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International Accounting Standards Board

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These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board meeting:	**20 June 2006, London**
Project:	**Amendments to IAS 37**
Subject:	**Reconsidering the probability recognition criterion (Agenda Paper 3A)**

INTRODUCTION

1. Paragraph 14 of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* specifies that a liability (provision) should be recognised if:

   '(a) an entity has a present obligation (legal or constructive) as a result of a past event;

   (b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and

   (c) a reliable estimate can be made of the amount of the obligation.'

2. The Exposure Draft of amendments to IAS 37 proposed omitting criterion (b)—the 'probability recognition criterion'. Accordingly, the ED proposed that items meeting the definition of a liability should be recognised unless they could not be measured reliably. Uncertainty about the amount or timing of the economic benefits required to settle the obligation would be reflected in the measurement of the liability.

3. The Board justified the omission of the probability recognition criterion on the basis that 'in practice the criterion would have no effect in determining

whether liability should be recognised, because in all cases in which an unconditional obligation exists the criterion would be satisfied.'[1] In particular, the Board explained that for a stand ready obligation (eg a product warranty obligation), the criterion was satisfied because the outflow of resources was the (certain) provision of services.

4. The Board's full reasoning in the ED is provided in the Appendix to this paper.

5. The staff's assessment is that this proposal has proved to be the most controversial in the ED. A very few respondents agree that it is conceptual improvement to omit the probability recognition criterion.[2] However, almost all constituents perceive the change to conflict with the *Framework* because this specifies a probability recognition criterion. For example, [one respondent] states that the '*Framework* still includes probability of an outflow of resources embodying economic benefits in determining whether a liability should be recognised, therefore we believe that moving probability from a recognition criterion to a measurement factor results in inconsistency with the *Framework*.'

6. This paper therefore reconsiders the proposal. After the staff recommendation it is structured as follows:

Section 1: Clarifying the role of the probability recognition criterion [paragraphs 8—21]

Section 2: Reconsidering whether the criterion is always satisfied [paragraphs 22—31]

Section 3: Another rationale to justify omitting the criterion from IAS 37 [paragraphs 32—40]

Section 4: Practical concerns about omitting the criterion [paragraphs 41—49]

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[1] Paragraph BC47, IAS 37 ED

[2] [Sentence omitted from observer notes]. Nonetheless, [these respondents] comment on the fundamental nature of the proposed change. For example, [one respondent] notes that the Board 'may have failed to appreciate the potential significance of the proposed changes and the potential for controversy in the marketplace'.

Section 5: Relationship of the proposal to the current *Framework* [paragraphs 50—65]

Section 6: Final conclusions and recommendation [paragraph 66]

STAFF RECOMMENDATION

7. The staff recommends that if the Board affirms the measurement requirements proposed in the ED, then the probability recognition criterion should be omitted from the revised IAS 37.

1: CLARIFYING THE ROLE OF THE PROBABILITY RECOGNITION CRITERION

Is the criterion related to resolving element uncertainty?

8. The staff thinks that we need to start by clarifying some misunderstanding about the probability recognition criterion in the current IAS 37. We say this because we think that some respondents view the probability recognition criterion as a means of determining whether a liability exists. For example, [one respondent] states that 'the probability criterion has proven to be a practical basis for … identifying … liabilities' and [another respondent] 'we believe that the probability recognition criterion should be retained when determining whether there is a liability to be recognised'.

9. Conceptually, however, the staff thinks that liabilities should be identified by considering whether items satisfy the liability definition. That, after all, is why we have a definition for a liability. This view is consistent with the current *Framework*. This states that recognition is the process of incorporating *elements* in the financial statements.[3] Hence, *before* considering the recognition criteria, a potential candidate for liability recognition must first have been evaluated against the liability definition and determined to be a liability. Thus, the probability recognition criterion in the *Framework* should not be viewed as a means of resolving uncertainty about whether an item is a liability (ie resolving element uncertainty).

10. This is particularly important in the light of last month's clarification of the meaning of the words 'expected to' in the liability definition. The Board

[3] Paragraph 82, *Framework*. [Sentence omitted from observer notes].

indicated that no specific level of expectation is required for something to satisfy the definition of a liability. So long as there is at least a non-zero possibility of an outflow of resources associated with a present obligation, that obligation satisfies the definition of a liability. Accordingly, the focus in determining whether there is a liability has to be on determining whether there is a present obligation, not considering the probability of an outflow of resources.

11. The staff notes that the existing IAS 37 is largely structured consistently with the *Framework*. Hence, an entity is first required to determine whether it has a present obligation (paragraph 14(a)—see paragraph 1 above) before considering whether settlement of that present obligation will probably require an outflow of resources (paragraph 14(b) —see paragraph 1 above).

12. The staff also notes that paragraph 15 addresses scenarios in which is it is uncertain whether there is a present obligation and, hence, a liability:

> 'In rare cases it is not clear whether there is a present obligation. In these cases, a past event is deemed to give rise to a present obligation if, taking account of all available evidence, it is more likely than not that a present obligation exists at the balance sheet date.'

Paragraph 15, however, supports paragraph 14(a), not the probability recognition criterion in 14(b). Therefore, the staff thinks that it is reasonable to assert that the probability recognition criterion in the existing IAS 37 (paragraph 14(b)) should also not be viewed as a surrogate for determining whether a liability exists.[4]

13. Accordingly, the staff has concluded that some respondents who have objected to the omission of the probability recognition criterion in IAS 37 are, in fact, objecting to the omission in the ED of paragraph 15, ie the use of probability in determining whether a present obligation/liability *exists*.

14. For example, in connection with the omission of the probability recognition,[one respondent] states 'we believe that a liability should not be recognised before an appropriate level of certainty is achieved'. The staff suspects that had we retained paragraph 15 of IAS 37 in the ED but still omitted the probability recognition criterion (in other words, retained a more likely than not test for liability identification), constituents might have been

[4] [Footnote omitted from observer notes]

less hostile to the ED.[5] For example,[one respondent] indicates that it could accept omitting the probability recognition criterion if the Board reinstated paragraph 15 and provided greater clarity about the distinction between a liability and a business risk.

15. The Board discussed the role of probability in liability identification last month. It noted that the question that it was trying to address was whether an entity has a liability, not whether the entity probably has a liability. Nonetheless, some Board members indicated that we may need to retain some notion of probability to assist in resolving element uncertainty. If we do, however, the staff thinks that we will be using probability similar to paragraph 15 of IAS 37 and not paragraph 14(b). That is, we will be asking whether it is probable that the entity has a present obligation and not whether it is probable that the present obligation will result in an outflow of resources.

What is the role of the probability recognition criterion in the Framework?

16. Having concluded that the probability criterion in the current *Framework* is not about liability identification, we can now consider what is its role.

17. Paragraph 83 of the Framework states that:

‘An item that meets the definition of an element should be recognised if:

(a) it is probable that any future economic benefit associated with the item will flow to or from the enterprise; and

(b) the item has a cost or value that can be measured with reliability.’

18. As applied to liabilities, this implies that a particular degree of certainty about the outflow of economic benefits is required before a liability is recognised or, put another way, that a particular degree of uncertainty would preclude recognition of the liability. This is consistent with paragraph 50 of the *Framework*[6] that clarifies that while a sufficiently certain expectation of an inflow or outflow of economic benefits is required for asset and liability recognition, the same is not true for asset or liability definition.

[5] [Footnote omitted from observer notes]

[6] ‘The definitions of an asset and a liability identify their essential features but do not attempt to specify the criteria that need to be met before they are recognised in the balance sheet. Thus, the definitions embrace items that are not recognised as assets or liabilities in the balance sheet because they do not satisfy the criteria for recognition discussed in paragraphs 82 to 98. In particular, the expectation that future economic benefits will flow to or from an enterprise must be sufficiently certain to meet the probability criterion in paragraph 83 before an asset or liability is recognised.’

19. The *Framework* does not explain what threshold is meant by probable. It is only IAS 37 that assigns the specific threshold of 'more likely than not'.[7] Furthermore, IAS 37 explains that this interpretation of probable does not necessarily apply in other Standards (and, presumably, the *Framework*).[8]

20. Nonetheless, the *Framework* contemplates the probability recognition criterion as an intermediary step between liability identification and measurement. And it is because the ED proposed eliminating the equivalent intermediate step in IAS 37 that respondents believe that the ED is inconsistent with the *Framework*.

21. In the ED, the Board argued that such an intermediate step was redundant because the criterion would always be satisfied. Hence, the criterion could be omitted. Accordingly, the staff next reconsiders the rationale for this conclusion.

2: RECONSIDERING WHETHER THE CRITERION IS ALWAYS SATISFIED

22. The staff first notes that in many cases, entities will not even consider the probability recognition criterion. This is because, in many cases, there will be very little uncertainty that the present obligation will entail *some* outflow of resources, even if there is significant uncertainty about the timing and amount of that outflow. Hence, an outflow of resources will be probable and the criterion satisfied. The staff suspects that this will be the case even with some more difficult liabilities. For example, assume that an entity has an obligation that is subject to litigation. To preclude recognition, there has to be at least a 50 per cent likelihood of that litigation resulting in *no* outflow. In other words, in applying the current IAS 37 in this example, we do not think that an entity should consider whether it will probably be required to pay the amount *claimed* by the litigant.

23. Secondly, for stand ready obligations (such as warranty obligations), the staff continues to believe that the probability recognition criterion can be regarded as satisfied. The *Framework* refers to an outflow of economic benefits, not just direct cash flows. Therefore, whilst the entity is standing ready it is providing a service to the counterparty and there is a flow of benefits between

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[7] Paragraph 23, IAS 37

[8] Footnote to Paragraph 23, IAS 37

the two. For example, the issuer of a warranty is providing a service in the form of risk protection. Hence, the probability recognition criterion is satisfied.

24. The staff notes that some respondents disagree with this interpretation or believe that it is too much of a stretch of the current *Framework* [remainder of sentence omitted from observer notes]. For example,[one respondent] disagrees that the outflow of resources in a warranty is the standing ready (ie the provision of risk protection). Rather it states that the outflow of resources is the outflow that will occur 'only if and when the equipment under warranty fails and is accepted for repair by the entity'. Hence, these respondents are stating that a liability for the warranty obligation should be recognised only if and when it is probable that the equipment will fail and require repair.

25. However, the staff thinks that this application of the probability recognition criterion must be flawed. It would mean that a warranty would qualify for initial recognition only when it is probable that a claim would arise. Hence, if an entity received a fee for issuing a warranty and if it assessed a claim to be improbable, then the entity would not recognise a liability but a gain, even though the entity has an obligation to provide warranty coverage. Similarly, an entity that prepaid for a year's warranty coverage would be unable to recognise an asset unless it thought it would probably make a claim under the warranty. Neither of these outcomes appears sensible to the staff. Nor do we find IAS 37's resolution of the warranty recognition problem satisfactory (although we acknowledge some of our constituents indicate that they do), ie to consider the probability of an outflow of resources for a portfolio of warranties as a whole. The staff views an entity with a single warranty obligation as having the same rights and obligation as an entity that has a portfolio of warranty obligations. Recognition of an obligation should not depend on whether an entity has one such obligation or a portfolio of similar obligations.

26. Nonetheless, as the staff emphasised in last month's paper on stand ready obligations, this interpretation means that for there to be a stand ready obligation, we must be able to articulate the nature of the service that is being provided whilst the entity is standing ready. We think this should always be possible in the case of an obligation stemming from a contract (whether the

obligation arises from an explicit term of the contract or is an implied term as a result of prevailing legislation). However, for non-contractual obligations articulating the nature of the service becomes more difficult [remainder of paragraph omitted from observer notes].

27. So are there any liabilities for which an outflow of resources would *not* be probable? The staff thinks that there may be. For example, an entity may have violated a regulation but consider it not probable that the violation will be detected. We can also envisage some conditional environmental clean-up obligations in which the event that would require the clean-up may not be probable.

Conclusion

28. On reconsidering the probability recognition criterion, the staff acknowledges that the criterion might not always be satisfied. Nonetheless, despite the overwhelming objection to the proposal to omit the probability recognition criterion, the staff believes that the criterion as articulated in the current IAS 37 should have only a limited role in determining whether *liabilities* should be recognised (because we do not believe that the criterion is related to determining whether items are liabilities).

29. The staff, however, is concerned that the arguments about redundancy as presented in the ED are insufficiently robust to justify omitting the probability recognition criterion. We also acknowledge that the arguments supporting the stand ready obligation are complicated and, possibly, pertain only to contractual obligations.

30. The above analysis therefore suggests two possible amendments to the ED: (a) restore the criterion, but explain that it is always satisfied for stand ready obligations and (b) restore the criterion, but explain that it is always satisfied for contractual obligations. Of the two we would prefer (b) because we would be concerned about placing stress on the distinction between a stand ready obligation and other liabilities. [9]

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[9] For example, a warranty can be described as a stand ready obligation—the entity is unconditionally standing ready to repair or replace the warranted product. It could also be simply described as an unconditional obligation to provide warranty coverage. Similarly, almost any asset retirement obligation can be described as stand ready obligation—the entity is standing ready to rectify past

31. However, we have considered whether there is another rationale for omitting the probability recognition criterion. This is discussed in the next section.

3: ANOTHER RATIONALE TO JUSTIFY OMITTING THE CRITERION

32. The *Framework* explains that the 'concept of probability is used in the recognition criteria to refer to the degree of uncertainty that the future economic benefits associated with the item will flow to or from the entity.' The staff thinks that this concept of using probability about the outflow of resources associated with a liability to determine recognition is inconsistent with the measurement requirements proposed in the ED (and, we think, the *current* requirements).

33. We say this because the ED proposed that a liability be measured 'at the amount that [an entity] would rationally pay to settle the present obligation or to transfer it to a third party on the balance sheet date'[10] The staff thinks that such an amount would reflect all of the uncertainty associated with the present obligation, ie all of the possible outcomes. This is because informed parties would take into account those uncertainties or possible outcomes in estimating the amount at which they would settle or transfer. Thus the measurement of a liability under IAS 37 is required to incorporate *all* possible outcomes, whether or not they are probable, even though outcomes that are not probable, if considered individually, would not qualify for recognition.

34. Accordingly when the probability recognition criterion is satisfied in IAS 37, *all* of the possible cash flow scenarios are reflected in the measurement of the liability. However, if the criterion is not satisfied, *none* of the possible cash flow scenarios are captured because the liability is not recognised. This means that similar obligations may be treated very differently.

35. To illustrate this consider a liability with a range of possible outflows, say 55 per cent chance of CU0.2m, 35 per cent chance of CU0.5m and a 10 per cent chance of CUnil. In this case there is a 90 per cent chance of an outflow of resources, so a liability would be recognised. The measurement would

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damage at the end of the asset's life. However, in the past we have just viewed these as unconditional obligations to rectify past damage at some time in the future.

[10] This measurement requirement was derived from paragraph 37 of the current IAS 37. This explains that the 'best estimate' of the expenditure required to settle the present obligation is the 'amount that an entity would rationally pay to settle the obligation at the balance sheet date or to transfer it to a third party at that time.'

reflect all of the uncertainties and hence would be based on CU0.29 (ie 0.55 × CU0.2 + 0.35 × CU0.5 + 0.1 × nil). However, if the possible outflows were 55 per cent chance of nil, 35 per cent chance of CU0.8m and 10 per cent chance of CU0.1 no liability would be recognised, so that *none* of the possible outflows would be reflected in the measurement. Yet, in the second scenario, all of the possible outcomes could just as well be reflected in the measurement of a recognised liability. Furthermore, the expected cash flows in the two scenarios are approximately the same, so similar obligations are being treated very differently. The staff can see no reason why recognition should be delayed in the second scenario.

36. The Board has already pointed out this inconsistency in its Basis for Conclusion to IFRS 3 *Business Combinations*. This highlights that:

> 'the probability recognition criterion applying to liabilities in IAS 37 and the *Framework* is fundamentally inconsistent with any … expected value basis of measurement because expectations about the probability that an outflow of resources embodying economic benefits will be required to settle a present … obligation will be reflected in the measurement of that … present obligation.'[11]

Interaction of a probability recognition criterion with measurement

37. As far as possible in the redeliberations, the staff is trying to separate issues and consider them one by one. However, at this point, we think we have to raise some of the respondents' concerns about the proposed measurement requirements in the ED. This is because we think that many respondents have disagreed with eliminating the probability recognition criterion because they also disagree with the Board's proposed measurement requirements (ie to measure at the amount the entity would rationally pay to settle or transfer on the balance sheet date). We say this because some respondents claim that eliminating the probability recognition criterion results in 'less meaningful information'[12] and the recognition of '"liabilities" without substance, ie [liabilities] which will most likely never lead to an outflow of resources'[13]. By this they mean that they do not think that recognising a liability based on, say, CU0.25 provides a useful depiction of the entity's future cash flows if there is

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[11] Paragraph BC112, IFRS 3
[12] [Footnote omitted from observer notes]
[13] [Footnote omitted from observer notes]

only a 25 per cent probability of a payment of CU100 and 75 per cent probability no payment.

38. In the staff's view, comments such as these [part of sentence omitted from observer notes] indicate that some respondents believe that the measurement in IAS 37 is intended to depict the ultimate settlement amount, ie reflect the entity's best guess about the eventual outcome. For example, [one respondent] states that an entity is aiming to estimate 'the potential outflow which will probably occur'. Similarly a letter from [one] European [based group of] preparers[14] says that 'if financial statements are to reflect management's expectation about future cash flows, those cash flows have to be probable'. That is, a liability of CU0.25m should depict the entity's expectation that it will probably eventually pay out CU0.25m (adjusted for the time value of money if it is material). However, the Board's view is that the measurement objective in IAS 37 is to estimate the amount required, on the balance sheet date, to settle or transfer the liability.

39. We need to convince constituents that reflecting probability in measurement is not misleading. On the contrary, it adds information to the balance sheet. This is because it captures *all* of the information about the uncertainty associated with the liability that exists on the balance sheet date. In the example in the preceding paragraph, recognising CU0.25m rather than nil reflects exposure at the balance sheet date to deviations of outcome from the most likely outcome of nil. Accordingly, the measurement provides superior information in the balance sheet, because it captures more information than a single point most likely estimate of nil. We need to emphasise that although the eventual outflow is most unlikely to be CU0.25, that would not mean that CU0.25 was 'wrong'. Rather, CU0.25 captures the uncertainties existing at the balance sheet date. Over time, those uncertainties change and, hence, so does the measurement. But the liability is not being 'trued up'—it is being remeasured to reflect the latest information. We note that one user clearly supported the approach and explains that 'financial statement users are now comfortable with … the significance of probability-weighted numbers. In other words, [users] recognise that a liability measured on the basis of

[14] [Footnote omitted from observer notes].

expected cash flows will likely not be the amount at which an obligation is ultimately settled'.[15]

Conclusion

40. The Board will need to consider measurement in due course. However, if the Board affirms the measurement proposals in the ED, the staff thinks that the Board's comment in the Basis for Conclusions to IFRS 3 is equally relevant to IAS 37. That is, a probability recognition criterion is inconsistent with the proposed measurement requirements and delays including decision-useful information in the balance sheet [remainder of paragraph omitted from observer notes].

4: PRACTICAL CONCERNS ABOUT OMITTING THE CRITERION

41. Having developed another conceptual argument for omitting the probability recognition criterion in IAS 37, the staff now considers practical concerns about the proposal.

42. Some respondents stated that the probability recognition criterion was a useful and practical way of excluding some liabilities and were concerned about the increased number of liabilities that would be recognised under the proposals. For example,[one respondent] notes that 'the proposed approach is likely to lead to the recognition of an increased population of liabilities with a low probability level of occurrence therefore increasing materially the cost of producing information which is not more relevant'. Similarly [another respondent] is 'concerned that, unless probability is taken into account in recognising liabilities, the number of items to be assessed and measured will increase inappropriately and that items will be recognised at implausible amounts rather than having the issues disclosed and discussed'.

43. The staff has addressed the comment about relevance and implausibility above in paragraphs 38 and 39. The staff also notes that for items that the ED would have required to be recognised, there would have been no loss of disclosure

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[15] This is from [one respondent's] response to the FASB's ITC based on IAS 37. The letter also notes that when FAS 5 was issued in 1975 the use of probability theory for decision making was in its early stages, the Black-Sholes model, for example, only being formulated in 1973. [O]nly [one] user group responded to IAS 37. This body accepted the logic of the proposals 'but remains to be persuaded whether [the] proposals actually represent an effective advance in financial reporting', principally because of practical concerns about measurement and commercial confidence.

and discussion compared with that required by the existing IAS 37. The only loss of disclosure relates to items that are labelled contingent liabilities under the exiting IAS 37 but which are not liabilities. And the staff intends to revisit this issue next month.

44. This then leaves the concern that the ED would require an 'inappropriate' increase in the number of liabilities to be recognised. In response to this the staff first notes that the scope of IAS 37 is quite narrow—the majority of an entity's liabilities are accounted for under other Standards (principally IASs 18 *Revenue* and 39 *Financial Instruments: Recognition and Measurement*). Secondly, we note that liabilities that the ED would have required to be recognised would already have been disclosed under the existing IAS 37 (unless they were previously classified as 'remote' contingent liabilities). Furthermore, IAS 37 requires that, when practicable, such liabilities be measured consistently with the measurement requirements[16] [remainder of paragraph omitted from observer notes].

45. In fact, the staff thinks that the perception that there will be many more liabilities to recognise relates to the issue we discussed last month, namely that many respondents think that the ED is suggesting that some business risks are liabilities. Therefore, we hope that once we better explain the boundary between a liability and a business risk, entities will be less concerned about the recognition requirements. We suspect that this will highlight that many 'remote' contingent liabilities are business risks and not *present* obligations.

46. We noted that a few respondents suggested at least having a 'remote' recognition threshold. For example,[one respondent] says 'we believe that there should be a subset of liabilities which are not recognised because the probability of any outflow of benefits is remote'. In the staff's view having such a threshold should be unnecessary—we do not think there would be much benefit in just lowering the probability threshold in IAS 37. This is because the usual considerations about materiality apply. In addition, if a 'remote' liability would not be immaterial (perhaps because there is a low likelihood of a significant cash flow), then recognition of that liability

[16] Paragraph 86, IAS 37: 'Unless the possibility of any outflow in settlement is remote, an entity shall disclose for each class of contingent liability at the balance sheet date a brief description of the nature of the contingent liability and, where practicable: (a) an estimate of its financial effect, measured under paragraphs 36-52; …'.

provides relevant and decision-useful information (if it can be measured reliably). In other words, we should not ignore liabilities just because they may have a remote possibility of resulting in an outflow.

47. The staff notes that some of the concerns about recognising low probability or remote liabilities actually relate to concerns about whether such liabilities can be estimated reliably enough to be included in the financial statements. For example, [one respondent] says that ‘removing the [probability recognition] step could result in excessive reliance on the measurement procedure which under this proposal is highly judgmental and difficult to substantiate’ and [another respondent] says ‘we believe that in numerous instances it is indeed very difficult to measure reliably the outcome and probability of an event or transaction, particularly when evaluating events or scenarios that a company regards as highly unlikely’.

48. Such concerns, however, relate to the reliable measurement criterion, not the probability recognition criterion. The staff acknowledges that eliminating the probability recognition criterion places more stress on the reliable measurement recognition criterion (although we do not think that there is necessarily a direct correlation between a low probability of an outflow and an inability to measure reliably). We therefore may need to provide more guidance on this point (and this will be the subject of another paper). However, the staff thinks that we should address this issue of reliable measurement directly, not avoid it by retaining the probability recognition criterion.

Conclusions

49. The staff does not believe that the practical concerns raised by respondents justify reinstating the probability recognition criterion. However, we think that they highlight (a) the importance of clarifying the distinction between a liability and a business risk (as discussed last month) and (b) the need to reconsider whether further guidance about reliable measurement will be required in the revised Standard.

5: RELATIONSHIP OF THE PROPOSAL TO THE CURRENT FRAMEWORK

50. Finally, the staff considers the relationship of (a) the proposal in the ED and (b) the analysis in section 3 with the current *Framework*.

51. In the ED the Board argued that its interpretation of the probability recognition criterion was consistent with the *Framework*. Very few respondents agreed, however. For example,[one respondent] said ‘we disagree with the Board’s interpretation to disregard the separate recognition criteria and respectively “transforming” the probability criterion into a simple question of measurement. In our view, the recognition without fulfilment of the probability criterion is not allowed according to the *Framework*’.

52. Even the few respondents who accepted that the interpretation might be consistent with the *Framework*, nonetheless noted that it represents a significant change in the established interpretation of the *Framework*. That is to say, they suggest that if the Board’s interpretation of the probability recognition criterion was contemplated by the authors of the *Framework*, the criterion would not have been included because it would be superfluous. Hence, some concluded that the Board’s reinterpretation is tantamount to a change of the *Framework*.

53. [First sentence omitted from observer notes]. [S]ome [respondents] explain why they place importance on consistency with the *Framework*. For example, [one] explains that ‘Introducing major changes in the way the EDs are proposing damages the authority of the *Framework* and creates the risk that changes that may be appropriate in particular circumstances will at some future date be extended to other circumstances without proper debate. If changes to existing concepts are being considered, we think they should first be discussed in the context of a debate on the *Framework*.’ Similar,[another respondent] says that ‘such a fundamental change to the *Framework* is likely to have far wider implications and so should be addressed through an overall consideration of the *Framework*, as opposed to piecemeal when new Standards are introduced’.

54. Some respondents have also reminded the Board that it indicated in the Basis for Conclusions to IFRS 3 that any review of the probability criterion would have to be dealt with in the concepts project.[17]

55. In the light of these comments the staff has considered whether the probability recognition criterion should be reinstated, pending a review of the probability recognition criterion in the *Framework*. However, in our view, in this instance the existing *Framework* should not by itself prevent us from omitting the probability criterion from IAS 37. In other words, we do not think that the *Framework* should be regarded as immutable. for the following reasons:

(a) the stand ready notion is a logical extension of the *Framework*,

(b) the probability recognition criterion in the *Framework* is confused and unnecessary,

(c) it is questionable whether the probability recognition criterion, as applied in IAS 37, is a fundamental concept underpinning our current Standards.

(a) The stand ready notion is a logical extension of the Framework

56. The staff has explained in paragraph 23 that, despite the comments received, it continues to believe that it is a reasonable interpretation or extension of the *Framework* to admit the notion of a stand ready obligation.

57. Furthermore, we emphasise that without the stand ready notion, the *Framework* would imply that many contractual obligations should not be recognised. For example, an insurance obligation, product warranty or guarantee would not qualify for initial recognition except in the unusual circumstances that a claim was assessed to be probable. To the staff, this highlights a major conceptual flaw in the *Framework*.

(b) The probability recognition criterion in the Framework is confused and unnecessary

58. [Paragraph omitted from observer notes]

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[17] Paragraph BC112 of Basis for Conclusions to IFRS 3: ‘the Board agreed that the role of probability in the *Framework* should be considered more generally as part of a forthcoming Concepts project.’

59. [Paragraph omitted from observer notes]

60. [Paragraph omitted from observer notes]

61. [Paragraph omitted from observer notes]

62. The staff, therefore, thinks that the work that we are doing in this project further highlights the difficulties and problems associated with the *Framework's* probability recognition criterion and the need for it to be addressed in the concepts project. Accordingly, in the staff's view the principal concept that we should be trying to apply in IAS 37 is the liability definition not the probability recognition criterion.

(c) It is questionable whether the criterion, as applied in IAS 37, is a fundamental concept underpinning our current Standards

63. The probability recognition criterion is not unique to IAS 37. However, whilst IASs 16 *Property, Plant and Equipment*, 40 *Investment Property* and 41 *Agriculture* contain the criterion, these standards contain no grey letter explanatory text to support the criterion, nor is the criterion discussed in any of the related Bases for Conclusions. [Sentence omitted from observer notes]. The Board also included the criterion in IFRS 3, but only for assets other than intangible assets and liabilities other than contingent liabilities [remainder of paragraph omitted from observer notes].

64. The other standard that contains the criterion, IAS 38 *Intangible Asset*, is perhaps more akin to IAS 37 because it deals with assets that have greater uncertainty. Here the standard explains that for a separately acquired intangible asset the criterion is satisfied, ie an entity does not need to consider the probability criterion. For internally generated intangible assets, the Standard explains that the main issues associated with determining recognition relate to 'identifying whether and when there is an identifiable asset that will generate *expected* future economic benefits' and 'determining the cost of the asset reliably'[18]. In other words, in IAS 38 recognition appears to be more of a question of determining whether (a) the *definition* of an intangible asset has

[18] paragraph 51, IAS 38

been satisfied and (b) the asset can be measured reliably, than about determining whether there is a probable inflow of benefits.[19]

65. [Paragraph omitted from observer notes]

6: CONCLUSIONS AND RECOMMENDATION

66. Subject to affirming the measurement requirements proposed in the ED, the staff recommends that the Board affirm its conclusion in the ED, namely that the revised IAS 37 should not include a probability recognition criterion. However, instead of just explaining that that criterion has been omitted because it is always satisfied, the staff recommends developing a more comprehensive explanation that captures the following points:

- The probability criterion as articulated in the *Framework* is confused. Furthermore, it is flawed, because in the absence of the notion of a stand ready obligation, it results in the obviously anomalous conclusion that liabilities such as guarantees, warranties, and insurance obligations should not be recognised until it is probable that claims will arise. Most such obligations would therefore not initially qualify for recognition. Accordingly, the *Framework* concept that we should be focussing on in the IAS 37 project is the liability definition.

- The only standard that, in practice, currently uses the probability recognition criterion to determine recognition is IAS 37. Furthermore, IAS 37 has established its own unique interpretation of probability.

- The probability recognition criterion as articulated in the current IAS 37 is not related to resolving element uncertainty. Hence, once an entity has concluded that it has a liability, the criterion, as articulated in the current IAS 37, would in most cases not be a determining factor in recognition.

- The notion of a stand ready obligation is a logical extension of the existing *Framework*. Contractual stand ready obligations entail a flow

[19] Although one of the recognition criterion (paragraph 57(a)) requires the entity to demonstrate 'how the intangible asset will generate probable future economic benefits'.

of economic resources while the entity is standing ready and, hence, satisfy the probability criterion as articulated in the current IAS 37.

- A probability recognition criterion is inconsistent with the measurement requirements proposed in the ED because it results in similar obligations being treated very differently. For liabilities that can be measured reliably, the criterion unnecessarily delays including decision-useful information in the balance sheet.

- Some of the concerns about omitting the probability recognition criterion are concerns about element uncertainty and measurement uncertainty. We are seeking to address these concerns directly. (The Board has already directed the staff to develop more guidance to assist entities in determining when a liability has been incurred. The staff will also be asking the Board to consider what is meant by reliable measurement at a later point in the redeliberations.)

APPENDIX

Extracts from the Basis for Conclusions to the IAS 37 ED

Probability recognition criterion

BC36 Having refined its analysis of items previously described as contingent liabilities, the Board concluded that it would need to reconsider the probability recognition criterion in IAS 37.

BC37 Paragraph 14(b) of IAS 37 specifies that a provision is recognised 'if it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation', 'probable' being defined as 'more likely than not'. The Board noted that in many cases, an entity does not need to make any assessment of the probability of an outflow because there is little or no uncertainty that settlement of the obligation will require *some* outflow of resources embodying economic benefits, even if there is significant uncertainty about the amount or timing of the outflow. An example is an entity that has an obligation to decommission a nuclear power station.

BC38 However, the Board noted that in some other cases application of the probability recognition criterion in IAS 37 was more troublesome. For example, in the case of a guarantee, Example 9 in the Standard explains that a guarantor applies the criterion by considering the probability of having to make a payment under the guarantee. This means that if the guarantee is issued in exchange for a fee, and it is not probable that a payment will be required under the guarantee, the guarantor does not recognise a liability. In the absence of the revenue recognition requirements of IAS 18, the entity would recognise a gain. This accounting is counter-intuitive, because an entity that has been paid to assume an obligation would recognise a gain on initial recognition, followed by losses if payments under the guarantee are made.

BC39 The Board acknowledged that in practice many guarantees within the scope of IAS 37 would be recognised because the Standard requires entities to consider recognition by reference to a portfolio (or class) of similar obligations. Thus, although it might not be probable that a payment will arise from a single guarantee, it is probable that *some* payment will arise in a portfolio of guarantees and, therefore, a liability is recognised. However, the Board decided that resolving a troublesome recognition issue in this way (ie by requiring recognition on a portfolio basis) is conceptually unsatisfactory. It would be better if the probability recognition criterion could be applied consistently for single guarantees and portfolios of guarantees.

BC40 Having analysed the obligations in transactions such as guarantees and warranties into conditional and unconditional obligations, the Board observed that the probability recognition criterion in IAS 37 is sometimes applied to the 'wrong' obligation. This is because it is applied to the conditional obligation (ie the contingency) rather than the unconditional obligation (ie the contractual stand ready service obligation). For example, in the case of a guarantee, it is applied to the guarantor's conditional obligation to make a payment under the guarantee. Similarly, in the example of a product warranty (Example 1 in the Standard), the criterion is applied to the entity's conditional obligation to repair or replace the product.

BC41 The Board concluded that applying the probability recognition criterion to the conditional obligation conflicted with the *Framework*. This is because paragraph 82 of the *Framework* describes recognition as 'the process of incorporating in the balance sheet or income statement an item *that meets the definition of an element*' (emphasis added). In other words, the *Framework* requires an entity to determine whether a liability exists before considering whether that liability should be recognised. As explained in paragraph BC24, in the case of a guarantee or a product warranty, the liability that is being considered for recognition is the unconditional obligation to stand ready to provide a service over the period of the guarantee or the product warranty. It is not the conditional obligation to make a payment under the guarantee or to repair or replace the product. Hence, the question is whether settlement of the present obligation (ie the unconditional obligation) to provide a service will probably result in an outflow of economic benefits, and not whether the conditional obligation to make a payment or to repair the product will probably result in an outflow of resources.

BC42 The *Framework* articulates the probability recognition criterion in terms of a flow of economic benefits. It also explains that the outflow required to settle a liability can occur in various ways. In particular, it explains that the outflow of resources can be the provision of services. The Board reasoned that because an entity that issues a guarantee or a product warranty has an obligation to provide a service—because it is contractually obliged to honour claims—the outflow of resources that is required to settle this obligation should be regarded as the provision of services over the term of the contract, and not the possible payments under the guarantee or product warranty.

BC43 Viewing the outflow of resources as the provision of services means that an entity that issues a guarantee or a product warranty satisfies the probability recognition criterion by definition. This is because it is certain that the stand ready obligation would require an outflow of resources in settlement. The assessment of the probability of an outflow of resources is independent of the likelihood of a claim arising under the guarantee or product warranty. In other words, even if it is highly unlikely that a claim will arise, the probability recognition criterion is still satisfied. As noted above, the probability of a claim arising relates to the likelihood of the *conditional* obligation becoming a present obligation. Accordingly, the Board concluded that the probability of a payment or claim arising under a guarantee or warranty should not determine whether the entity's *present* obligation to provide a service should be recognised. Rather, the likelihood of claims arising should be reflected in the measurement of that present obligation.

BC44 The Board's conclusions about the application of the probability recognition criterion in the case of warranties and guarantees are consistent with FIN 45. This Interpretation explains that a guarantor has incurred a liability on issuing a guarantee that qualifies for recognition, even if it is not probable that the specified triggering events or conditions that would cause payments under the guarantee will occur. The FASB concluded that the outflow of resources associated with the unconditional obligation to stand ready to perform over the term of the guarantee is the requirement to 'stand ready to provide services' and not the possible payments required under the guarantee.

BC45 The Board observed that its analysis of the application of the probability recognition criterion to a guarantee or product warranty could be extended to any liability arising from an unconditional contractual obligation accompanied by a conditional obligation. This is because such liabilities arise from the contractual obligation to stand ready to provide a service. For example, an entity that is jointly and severally liable with another entity, but expects that other entity to be responsible for the obligation, is providing a service to the counterparty because the counterparty has the right to look to the entity to honour the obligation (ie the entity is standing ready to honour the obligation). Similarly, a retailer that is obliged, contractually or constructively, to offer refunds to dissatisfied customers is providing a service to its customers because those customers have a right to return their products (ie the retailer is standing ready to accept returns).

BC46 The Board then considered liabilities that accompany non-contractual contingent liabilities. As noted above, the Board decided that the relationship between conditional and unconditional contractual obligations could be extended to non-contractual obligations. For example, in the case of a lawsuit, the Board observed that although the penalties that a defending entity might be required to pay are a conditional obligation, the entity has no discretion to do otherwise than perform as directed by the court. Therefore, the Board concluded that the entity also has a present (ie unconditional) legal obligation, namely an obligation to stand ready to pay any penalties awarded by the court. Because the outflow of resources is the standing ready (ie the provision of a service), rather than the possible damages, the Board concluded that the probability recognition criterion is satisfied. It is certain that the entity is obliged to accept any obligation imposed by the court. In effect, the court's ability to impose settlement stands in the place of a contract.

BC47 The Board observed that the above conclusions about the application of the probability recognition criterion mean that in practice the criterion would have no effect in determining whether a liability should be recognised, because in all cases in which an unconditional obligation exists the criterion would be satisfied. Therefore, the Board considered whether it should retain the probability recognition criterion in the Standard. The Board noted that the criterion might be misapplied in some situations. In particular, it might be applied to the entity's conditional obligation rather than to its present obligation, in cases in which an entity has two obligations, with the result that liabilities are not recognised. The Board also noted that there is anecdotal evidence to suggest that some use the criterion to determine whether they have incurred a liability, instead of determining whether the definition of a liability has been satisfied. This could result in an entity that has a conditional obligation with a very high probability of an outflow of economic benefits concluding that it should recognise a liability. However, if the definition of a liability is not satisfied (in particular, if there is no present obligation), the entity should not recognise a liability. Similarly, relying on the probability recognition criterion to determine whether a constructive obligation exists could result in the recognition of items that are not liabilities. This is because in some cases an entity may conclude that there will probably be an outflow of economic benefits, even though it has no *obligation* to incur that outflow. Lastly, the Board noted that it would add unnecessary complexity to the Standard to specify a criterion that is always satisfied. Therefore, the Board decided to omit the criterion from the draft Standard.

BC48 The Board acknowledged that the criterion is derived from the *Framework* and, therefore, not including the criterion in the Standard might give the impression of inconsistency with the *Framework*. Indeed, the Board was aware that many of its constituents regard some of its recent Standards as inconsistent with the *Framework* because they do not contain a probability recognition criterion. However, the Board concluded that there would be no inconsistency. The apparent inconsistency arises only if the conditional or contingent obligation is being considered rather than the unconditional obligation. Having refined the analysis of liabilities in IAS 37 to focus on the unconditional obligation, the Board concluded that it was inevitable that the current interpretation of the probability recognition criterion in IAS 37 would need to be reconsidered. Nonetheless, the revised interpretation is consistent with the *Framework*. Furthermore, it results in consistent recognition of contractual obligations in accordance with IAS 37 and IAS 39, because the probability recognition criterion in the *Framework* is being applied in the same way in both Standards. For example, in considering the recognition of an option in accordance with IAS 39, an entity does not consider whether it is probable that the option will be exercised. Rather, the probability recognition criterion is applied to the unconditional obligation.