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

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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: **26 May 2006, London**

Project: **Amendments to IAS 37 (Agenda Paper 10A)**

Amendments to IAS 37: Approach to redeliberating the issues associated with the recognition principle proposed in the ED

INTRODUCTION

1. In accordance with the current redeliberation timetable, the staff asks the Board to begin discussing issues associated with the ED's recognition principle at the May and June 2006 Board meetings. The staff thinks that reconsidering the recognition principle proposed in the ED is one of the main areas of focus in the overall IAS 37 redeliberation process because many respondents disagree or express significant concerns about the amendments to IAS 37 proposed in the ED resulting from this principle.

2. At the February 2006 meeting the Board agreed that the proposed amendments in the ED are based on one recognition principle and two sub-principles:

> **Principle 2**: An entity shall recognise a liability when (a) the definition of a liability has been satisfied, and (b) the liability can be measured reliably.
>
> **Sub-principle 2.1**: Liabilities arise only from unconditional (non-contingent) obligations.
>
> **Sub-principle 2.2**: Any liability that incorporates an unconditional obligation satisfies the probability recognition criterion in the *Framework*. An entity shall reflect uncertainty about the amount or timing of the economic benefits that will be required to settle a non-financial liability in the measurement of that liability.

The purpose of the principle and sub-principles is to emphasise that an entity must first determine whether a transaction or event gives rise to a liability, as defined by the *Framework*. The staff notes that the current IAS 37 and the *Framework* already require an entity to first determine whether a transaction or event gives rise to a liability. But in emphasising this point, the ED proposes reflecting all uncertainty about the liability in measurement rather than recognition.

3. The objective of this paper is to provide an overview of the main concerns expressed in the comment letters and analyse exactly why many respondents reject or are concerned by the ED's proposals. In doing so, this paper also outlines the rationale underpinning the staff's approach to redeliberating the issues associated with the recognition principle proposed in the ED.

- First, the staff's approach focuses on narrowing down the issues. The staff notes that many respondents have rejected or expressed significant concern about the proposals resulting from the recognition principle. Therefore here the staff is seeking to identify the reasons *why* respondents reject or are concerned by the proposals.

- Secondly this paper splits the issue identified into two logical groups– the first group of issues will be presented at the May Board meeting and the second group of issues will be presented in June.

The staff notes that splitting the issues into logical groups is particularly important because there are overlaps between many of the issues. Therefore in some earlier papers the staff will need to state working assumptions about issues to be addressed later in the redeliberation process.

Question for the Board to consider

4. Are there any additional topics related to the ED's recognition principle that the Board would like to the staff to consider as part of the IAS 37 redeliberations?

NARROWING DOWN THE ISSUES

5. Many respondents reject or are concerned by principle 2. Some disagree with the proposal to eliminate the term 'contingent liability' but the majority disagree with the proposal to omit the probability recognition criterion from IAS 37. These respondents believe that probability has an important role to play in the recognition or non-recognition of 'uncertain' liabilities, not just in the measurement of liabilities. Equally, several respondents find term 'contingent liabilities' useful for describing 'uncertain' liabilities not recognised in the financial statements.

6. From the comment letters the staff has identified two main sources of uncertainty:

1) Uncertainty about the outflow of resources embodying economic benefits associated with a present obligation

2) Uncertainty about the existence of a present obligation

Uncertainty about the outflow of resources embodying economic benefits associated with a present obligation

7. The comment letters indicate that many respondents prefer retaining the existing probability recognition criterion in IAS 37 for two reasons. First, several respondents do not view the ED's proposals as consistent with the *Framework*. Secondly, the probability recognition criterion is viewed as a useful screen to exclude items from the balance sheet when it is uncertain whether a present obligation exists, or liabilities for which there is only a low or remote likelihood of a future cash outflow from the balance sheet.

Inconsistency with the Framework

8. Several respondents argue that the ED's proposals are not consistent with the *Framework* (or at least change an established interpretation of the *Framework*). This is because the *Framework's* definition of a liability includes the phrase '… the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits'[1]. Some respondents understand 'expected to' to mean 'probable' therefore argue that it is necessary to assess the likelihood of an outflow in determining whether or not a liability exists. The staff's initial thoughts are that the phrase 'expected to' has more than one definition and this has caused confusion about its meaning in the context of the *Framework*. Therefore the staff thinks that the Board may need to provide some guidance on the intended meaning of 'expected to' in the context of the *Framework*. For example, this guidance may follow the FASB approach which uses a footnote to explain the intended meaning of the term 'probable' in the context of a liability definition [2].

9. Additionally, the recognition criterion in the *Framework*[3] requires a probability assessment to determine whether a liability should be recognised. Therefore some respondents consider it inappropriate to consider probability only when measuring a liability. The staff intends to re-examine the conclusion in the ED that because an unconditional obligation always results in an outflow of resources the probability criterion is always satisfied. [*Last sentence omitted from observer notes*]

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[1] Paragraph 49: "A liability is a present obligation of the entity arising from past events, the settlement of which is *expected to* result in an outflow from the entity of resources embodying economic benefits" (emphasis added|).

[2] FASB Concepts Statement No. 6 *Elements of Financial Statements*, footnote 21: *Probable* is used with its usual general meaning, rather than in a specific accounting or technical sense (such as that in Statement 5, par. 3), and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved (*Webster's New World Dictionary*, p. 1132). Its inclusion in the definition is intended to acknowledge that business and other economic activities occur in an environment characterized by uncertainty in which few outcomes are certain (pars. 44-48).

[3] Paragraph 83(a): An item that meets the definition of an element should be recognised *if it is probable* that any future economic benefit associated with the item will flow to or from the entity …" (emphasis added). Paragraph 85: "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 …" (emphasis added)

A useful screen to exclude items from the balance sheet when it is uncertain whether a present obligation exists, or liabilities for which there is only a low or remote likelihood of a future cash outflow from the balance sheet

10. Some respondents consider that disclosure about liabilities for which there is only a low or remote likelihood of cash outflows provides more relevant and useful information to users of the financial statements than recognition of such liabilities. Other respondents to the ED and users of financial statements do not share that view and support the principle which will require an entity to recognise a liability if there is little or no uncertainty that a present obligation exists[4]. [*Remainder of paragraph omitted from observer notes*].

11. The staff's initial thoughts are that (subject to the probability recognition criterion constraint) the only justification for not recognising a liability when there is little or no uncertainty that a present obligation exists is that it is not possible to identify the range of possible outcomes with sufficiently reliability. This may mean that any attempt to measure the liability does not result in relevant information and reporting that liability in the balance sheet does not faithfully represent the financial position of the entity. Consequently, one of the issues the staff proposes to examine is the meaning of 'reliable measurement' and whether any final Standard needs to include more guidance explaining when it might not be possible to measure a liability with sufficient reliability[5].

Uncertainty about the existence of a present obligation

12. The comment letters indicate that some respondent believe many situations arise when it is not certain that present obligation exists ("element uncertainty").

Element uncertainty

13. Some respondents find the ED's analysis of unconditional and conditional obligations is useful in explaining *why* there is a liability but it does not explain how to determine *when* there is a liability. Therefore these respondents argue that, in lieu of a better solution, probability is a pragmatic tool to assist in determining whether a present obligation does exist in situations when element uncertainty arises.

14. The staff notes that the ED does provide limited guidance on addressing element uncertainty[6] but omits the current IAS 37 probability based guidance[7]. Therefore the staff's initial thoughts are that element uncertainty is not a new issue, but by emphasising that an entity must first determine whether a present obligation exists, the ED's proposals have raised awareness. The staff intends to consider whether any final Standard needs to include further

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[4] Assuming it can be measured reliably and subject to the usual materiality considerations.

[5] Similarly to FIN 47 *Conditional Asset Retirement Obligations*.

[6] Paragraph 16: "In determining whether a liability exists at the balance sheet date, an entity takes into account all available evidence, for example the opinion of experts. The evidence considered includes any additional information provided by events after the balance sheet date, but only to the extent that the information provides evidence of circumstances that existed at the balance sheet date".

[7] Paragraph 15 states that a present obligation does exist "… if, taking into account of all available evidence, it is *more likely than not* that a present obligation exists at the balance sheet date" (emphasis added).

guidance on how to address element uncertainty, and if so, what form that guidance should take. This may include limiting the application of some the ED's proposals to contractual situations because a contract clearly defines the parameters in which uncertainty related to the amount and timing of any future outflow can be assessed.

Litigation

15. Almost all respondents use the example of litigation to illustrate their concerns about implementing the proposals in the ED. The staff thinks that litigation is particularly problematic because litigation often involves multiple points of uncertainty. As a result on-going litigation may combines several recognition issues plus additional issues associated with the measurement principle, the treatment of legal costs and the disclosure requirements proposed in the ED. Consequently the staff intends to first discuss each of the issues associated with the ED's recognition principle without reference to litigation. Litigation will then be considered as a standalone topic.

GROUPING THE ISSUES

16. The staff has grouped its analysis and presentation of the issues associated with the recognition principle proposed in the ED based on these two main sources of uncertainty identified above. The staff intends to address the more problematic issues first. For completeness, the staff will also provide the Board with an analysis of *all* of the comments received on the principle 2 and sub-principles 2.1 and 2.2, including comments not related to sources of uncertainty.

17. Therefore in May the staff will focus on uncertainty about the existence of a present obligation and the definition of a liability in the *Framework*. These topics will be addressed as part of three papers.

    1) The meaning of the phrase 'expected to' in the Framework's definition of a liability,

    2) Element uncertainty

        (a) the need to provide further guidance addressing element uncertainty in any final Standard; and

        (b) the relative merits of alternative forms of guidance addressing element uncertainty including probability.

    3) Stand ready obligations

        (a) distinguishing between a general business risk and a stand ready obligation,

        (b) whether a possible change in law creates a stand ready obligation,

        (c) the relationship between a stand ready obligation and an executory contract, and

(d) whether the notion of a stand ready obligation can apply to non-contractual scenarios.

18. In June the staff will examine issues regarding uncertainty about the outflow of resources associated with a known present obligation, lawsuits and other issues raised in the comment letters.

1) The *Framework's* recognition criterion

(a) whether the ED's proposals are consistent with the *Framework's* recognition criteria, in particular whether a present obligation always results in an outflow of resources; and

(b) whether probability has a practical role to play in determining what constitutes relevant information to be included in the balance sheet.

2) Litigation

(a) identifying the obligating event;

(b) whether an entity has a stand ready obligation for at least the costs of defence once legal proceedings have begun; and

(c) whether recognition of a liability in the financial statements can unduly influence the outcome of litigation.

3) Other topics

(a) the clarity of the analysis and explanation provided in the ED, particularly the analysis of contingencies into conditional and unconditional obligations;

(b) eliminating the term contingent liability; and

(c) considering the inter-action between the recognition principle proposed in the ED and the recognition of liabilities following the guidance in other Standards, such as business combinations.

19. The staff acknowledges that considering what constitutes reliable measurement and other aspects of the proposed amendments to the measurement guidance in the ED are topics which are inextricably linked to some of the issues relating to the ED's recognition principle (including litigation). The staff has not included these topics in the schedule above because the redeliberation timetable allows time in September and October 2006 for addressing these issues.

20. The staff also notes that the nature of the issues raised for discussion at the May 2006 Board meeting and the diversity of views and options available, may necessitate further staff analysis and further discussion at a future Board meeting. This may require an amendment to the existing redeliberations timetable.