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: **26 May 2006, London**

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

Amendments to IAS 37: The meaning of the phrase "expected to" in the definition of a liability

INTRODUCTION

1. This paper forms part of a series of papers redeliberating the recognition principle underpinning the proposed amendments to IAS 37. Paragraph 49(b) of the *Framework* defines a liability as "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). The comments letters received in response to the proposed amendments to IAS 37 indicate that different views exist regarding the meaning of the phrase "expected to" in the definition of a liability. Therefore, this paper considers the meaning of the phrase "expected to" specifically in the context of the *Framework's* definition of a liability.

2. The paper is divided into three sections:

    a. Summary of recommendations

    b. Comment letter analysis

    c. Staff discussion

SUMMARY OF RECOMMENDATIONS

3. The staff recommends that in the Basis for Conclusions the Board confirms that:

(a) the phrase "expected to" is <u>not</u> intended to imply that there must be a particular degree of certainty that an outflow of benefits will occur before an item meets the *Framework's* definition of a liability.

(b) the Board's interpretation of the meaning of the phrase "expected to" in the IASB's definition of a liability (above) does not increase divergence with US GAAP.

COMMENT LETTER ANALYSIS

4. Several respondents argue that the phrase "expected to" in the *Framework's* definition of a liability requires an entity to determine whether an outflow of resources associated with an item is *probable* (ie a sufficient degree of certainty about the outflow of resources exists). These respondents argue that if an outflow of resources is not probable, there is no liability. In particular, these respondents comment that items with a remote or low likelihood of future settlement do not meet the definition of a liability. Therefore these items should not be recognised. Instead, if material, these items should be disclosed as contingent liabilities in the notes to the financial statements.

5. More generally, some respondents are also concerned that the ED's proposals will increase divergence with US GAAP. These respondents note that this outcome contradicts the IASB-FASB short term objective of convergence.

STAFF DISCUSSION

6. The staff acknowledges that the phrase "expected to" has a number of different definitions and that the 'sufficient degree of certainty' meaning adopted by respondents in their comment letters is valid. But the staff does not think that the phrase "expected to" (in the context of the *Framework*) is intended to imply that there must be a particular degree of certainty (sufficient certainty) that an outflow of benefits will occur before an item meets the definition of a liability. Rather, the staff thinks that the phrase "expected to" is being used to indicate that some potential outflow is necessary for an item to meet the definition of a liability.

7. The staff thinks that this problem arises because the *Framework* itself does not explain the intended meaning of "expected to". But the staff believes that its interpretation can be supported by (a) other parts of the *Framework*, principally the amplifying text accompanying the definition of a liability and the recognition criteria, and (b) applying the phrase to common transactions and events which are readily accepted as liabilities for financial reporting purposes. Moreover, the staff does not agree that its interpretation of the phrase "expected to" increases divergence with US GAAP.

Other parts of the Framework

8. The amplifying text accompanying the definition of a liability in the *Framework*[1] does not quantify the degree of certainty required for an expected outflow of economic benefits to exist. Paragraph 50 emphasises that the degree of certainty that future outflows from the entity will occur is addressed in the *Framework's* <u>recognition</u> criterion, not in the definition of a liability.

[1] Paragraphs 50 – 52 and 60 -64.

Paragraph 50 also explains that the *Framework's* definition of a liability includes items that are liabilities but are not recognised as liabilities in an entity's financial statements because they do not satisfy the recognition criteria (ie the outflow is not probable).

9. The amplifying text accompanying the recognition criteria in the *Framework*[2] also emphasises that a sufficient degree of certainty of an outflow is linked with the recognition of a liability in financial statements, not the existence of a liability. Paragraph 83 states that "an item *that meets the definition of a liability* should be recognised *if it is probable* …" and paragraph 85 explains that the concept of probability is used to refer to the degree of certainty that the future economic benefits associated with an item will flow from the entity. (As outlined in agenda paper 10A, the staff intends to discuss whether the ED's proposal to omit probability recognition criterion from IAS 37 is consistent with the *Framework's* recognition requirements at the June 2006 Board meeting. Therefore this issue is not discussed in this paper.)

10. [*Paragraph omitted from observer notes*]

Applying the phrase to common transactions and events

11. The staff also thinks the liability recognition guidance provided in other Standards supports the staff view that "expected to" means some potential outflow is required for the *Framework's* definition of a liability to be met (but that a particular degree of certainty is not required). One example is a forward exchange contract (and other derivative financial instruments). At inception and throughout the term of a FEC it may not be certain that an ultimate cash outflow will be required to settle the contract. But IAS 39 *Financial Instruments: Recognition and Measurement* requires an entity to recognise financial instruments at fair value. Therefore a liability will be recognised for any out of the money FECs at the balance sheet date.

12. Conversely, if a particular degree of certainty about a future cash outflow is required before an item meets the definition of a liability the staff thinks that many items that are generally accepted to be liabilities may no longer meet the definition of a liability. For example, insurance contracts and products warranties are generally accepted to be liabilities and are recognised in financial statements. But an insurance contract or a product warranty may not ultimately require an outflow of economic benefits. Therefore it is possible that these items would no longer be considered liabilities.

13. Based on the arguments outlined above, the staff thinks that the phrase "expected to" is not intended to imply that a particular degree of certainty about a future outflow of benefits is required for the *Framework's* definition of a liability to be met. The staff proposes to address the confusion caused by the absence of an explanation in the *Framework* by explaining why the ED's proposals do meet the definition of a liability in the IAS 37 Basis for Conclusions.

14. **Does the Board agree?**

Increased divergence with US GAAP

[2] Paragraphs 82 – 98.

15. FASB Concepts Statement No. 6 *Elements of Financial Statements* (paragraph 25) defines liabilities as "*probable* future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions" (emphasis added). A footnote explains that in this context the word 'probable' is simply intended to convey that certainty is not required for the definition of a liability to be met[3]. This explanation was reinforced in 1998 when the FASB published a Special Report emphasising that " … Probable is not an essential part of the definitions; its function is to acknowledge the presence of uncertainty and to say that the future economic benefits or sacrifices do not have to be certain to qualify the items in question as assets and liabilities, not to specify a characteristic that must be present." [4]

16. Recent Standards issued by the FASB[5] illustrate that they continue to understand that the word 'probable', in the context of defining a liability, does not require a particular degree of certainty about the future sacrifice of economic benefits before an item meets the definition of a liability. (This observation is already reflected in the ED's Basis for Conclusions (paragraph BC25).)

17. Based on the above, the staff does not agree that the Board's interpretation of the meaning of the phrase "expected to" in the IASB *Framework's* definition of a liability will increase divergence with US GAAP.

18. Does the Board agree?

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[3] Although the staff notes that US GAAP uses the term 'probable' in other contexts to describe situations in which the outcome is *likely* to occur.

[4] Storey, Reed and Storey, Sylvia, (January 1998), FASB Special Report, *The Framework of Financial Accounting Concepts and Standards*, page 131.

[5] For example, FIN 45 *Guarantor's Accounting and Disclosure Requirements, Including Indirect Guarantees of Indebtedness of Others*.