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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: **26 May 2006, London**

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

Amendments to IAS 37: Determining whether an entity has a liability when the existence of a present obligation is uncertain

INTRODUCTION

1. The IAS 37 ED takes as its starting point the definition of a liability in the *Framework*. As a result, the ED places emphasis on determining whether transactions or events result in a liability. According to paragraph 60 of the *Framework*, the essential characteristic of a liability is that an entity has a present obligation. In many circumstances it will be clear that a present obligation exists because a clearly identifiable past event ("the obligating event") has occurred. But in other circumstances the existence of a present obligation may be uncertain ("element uncertainty"). This paper considers how to determine whether an entity has a present obligation when element uncertainty exists.

2. As noted in agenda paper 10A, this issue forms part of the overall redeliberations on the recognition principle proposed in the ED. Different aspects of this recognition principle will be presented for Board discussion over a number of months. For the purposes of this paper the staff has assumed that the phrase "expected to" is not intended to imply that there must be a particular degree of certainty that an outflow of economic resources will occur before an item meets the *Framework's* definition of a liability. The meaning of "expected to" is addressed separately in agenda paper 10B.

3. This paper is divided into four sections:

   1. Summary of staff recommendations

2. Guidance on how to address element uncertainty included in the current IAS 37
3. Comment letter analysis
4. Staff discussion
    a. Addressing element uncertainty as part of this project
    b. Alternative options for addressing element uncertainty

SUMMARY OF STAFF RECOMMENDATIONS

4. The staff recommends that:

    a. Guidance on how to determine whether an entity has a liability when the existence of a present obligation is uncertain (element uncertainty) be addressed as part of this project and in any final Standard. [*paragraphs 12 – 14*]

    b. The additional guidance provided in any final Standard take the form of a list of indicators to assist an entity in determining whether a liability exists (option 4). [*paragraphs 16 – 36*]

GUIDANCE ON ELEMENT UNCERTAINY IN THE CURRENT IAS 37 AND THE ED

5. The staff notes that element uncertainty is not a new issue created by the ED. It is widely accepted that absolute certainty (in the general sense of both identifying and measuring elements) is not required before an element is recognised in financial statements. For example, paragraph 64 of the IASB *Framework* states that when a present obligation exists, it is a liability even if it can only be measured using a substantial degree of estimation. Similar statements are made in the accounting literature of other jurisdictions, including the US, Australia, Canada and the UK[1]. Moreover, some existing, national accounting guidance specifically refers to element uncertainty.

6. The *Framework* does not refer to element uncertainty. However, IAS 37 currently provides limited guidance on determining whether a present obligation exists in cases in which it is uncertain whether a past event has given rise to a present obligation. Paragraphs 15 and 16 state that such cases are rare. But, when uncertainty does exist, IAS 37 requires an entity to determine whether, after taking into account all available evidence, it is *more likely than not* that a present obligation exists at the balance sheet date. If it is, a present obligation is deemed to exist (and a liability recognised if the recognition criteria are satisfied). If not, a contingent liability (possible obligation) exists.

7. In contrast, the ED states that an entity takes into account all available evidence (including that which becomes available after the balance sheet date

[1] CON 6 Elements of Financial Statements, paragraphs 44 – 47; CICA 1000 *Financial Statement Concepts* paragraph 21 and CICA 1508 *Measurement Uncertainty*; SAC 4 *Definition and Recognition of Elements of Financial Statements*, paragraphs 64 and 127; and Statement of Principles for Financial Reporting, paragraphs 5.12 – 5.17

but which relates to circumstances existing at the balance sheet date[2]) in determining whether a liability exists. There is no ‘more likely than not’ criterion for the existence of a present obligation.

COMMENT LETTER ANALYSIS

8. Most respondents oppose omitting the probability guidance in IAS 37. Specifically in relation to determining whether a present obligation exists, many respondents agree with the Alternative View. These respondents state that by omitting probability based recognition criterion, the ED fails to provide adequate guidance to apply to situations when it is not clear that a present obligation exists. One constituent compares a financial guarantee to regulatory action to illustrate its concern. This comparison (paraphrased) includes the following observations:

> A financial guarantee represents an agreement between parties within fixed parameters. The acceptance of the guarantee contract is a clear past event that gives rise to a liability. Although the ultimate quantum required to settle the guarantee contract is of uncertain amount and timing, the uncertainty relates to the measurement of the liability not the existence of a present obligation.
>
> Unlike the financial guarantee, there is no clear point of obligation in regulatory action. For example, an initial regulatory enquiry may be prompted by a complaint about product mis-selling. At this point it is not certain that the alleged product mis-selling did occur. The outcome of that enquiry is uncertain and may require an industry response, further investigation and a final report. The outcome of any of these actions may or may not result in a fine and affect the ability of other customers to make a claim against entities selling that product. Uncertainty also exists in determining at what point in this continuum of uncertain events an entity has sufficient evidence to conclude that a present obligation does exist.

9. [*Beginning of paragraph omitted from observer notes*] Most respondents request that the Board provides some form of additional guidance addressing element uncertainty in any final Standard. Others specifically advocate retaining a probability based approach as a pragmatic solution to addressing element uncertainty.

10. Some respondents acknowledge that the current IAS 37 probability based approach to addressing element uncertainty does not provide a satisfactory and consistent answer. But they recommend retaining probability based guidance until a demonstrably better method is found. These respondents do not think there is sufficient demand from users, regulators or preparers to justify changing the current approach at this time. Other respondents think that it is more appropriate to consider element uncertainty at a conceptual level first. Therefore, these respondents recommend deferring the IAS 37 project until the conceptual framework project has concluded (or has at least progressed further).

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[2] In accordance with IAS 10 *Events after the Balance Sheet Date*

STAFF DISCUSSION

11. As acknowledged in agenda paper 10A, the issue of element uncertainty is closely related to a number of other issues scheduled for redeliberation in the coming months. Therefore the staff would like to emphasise that the following discussion and resulting recommendations are just one step in an overall package. Accordingly any conclusions following Board discussion of this paper will be tentative conclusions only.

Addressing element uncertainty as part of this project

12. The staff agrees with respondents that additional guidance on how to address element uncertainty needs to be included in the final Standard. This is for two reasons. First, the *Framework* currently provides no alternative point of reference in lieu of guidance at a standards level. The staff does not agree with those respondents who recommend deferring the IAS 37 project until the conceptual framework project considers element uncertainty (and the IASB *Framework* is potentially updated to include some form of guidance). This is because:

    (a) the Board has already confirmed that its standard-setting initiatives, including IAS 37, are not dependent on completing the conceptual framework project; and

    (b) the conceptual framework project team is planning to address uncertainty from first principles, whereas the objective of including additional guidance at a standards level is to ensure the requirements of that standard can be applied consistently.

13. Secondly, the staff would like to reconsider paragraph 15 of the current IAS 37 which states that only in rare cases is it not clear that a present obligation exists. The staff thinks that element certainty arises with sufficient frequency across all industries and jurisdictions to justify including additional guidance in the final Standard[3]. The staff thinks that element uncertainty may arise in three general situations:

    A *Did a past event actually occur?* In this scenario it is not clear whether a past event has occurred. If the event has occurred, that event will have resulted in a present obligation. However, the facts and circumstances relating to the past event are unclear. Therefore, it is not certain whether a present obligation exists. Examples include employee related claims (unfair dismissal, discrimination) and product mis-selling.

    B *Is there an alternative, credible interpretation?* In this scenario a contract, regulation or law may be interpreted in more than one way, therefore it is not clear whether an identified past event has resulted in a present obligation. Examples include disputes over the terms and conditions of a product warranty and different, but equally credible,

[3] In making this statement the staff notes that element uncertainty is not as pervasive an issue as suggested in some comment letters. Also, the staff notes that some situations used to illustrate element uncertainty in some comment letters in fact illustrate *measurement* uncertainty.

interpretations of existing laws regarding the use of patents, brand names or proprietary software.

C *Have cumulative circumstances and events provided sufficient evidence to indicate that a present obligation exists?* In this scenario a progression of events may indicate that management *intends* to act in a certain manner but is not yet demonstrably committed or compelled (by contract, regulation or law) to taking that action. Therefore it may not be certain whether a present obligation exists. One example is an entity which has publicised a commitment to clean-up damage caused to the environment in the course of its business operations even though there is no environmental legislation compelling the entity to do so.

Based on the above scenarios, the staff thinks that element uncertainty does not arise when a clear, indisputable contract, regulation or law applies to a transaction or event. However, constructive obligations and disputes may result in element uncertainty.

14. Because of the lack of alternative guidance available for addressing element uncertainty and the potential for element uncertainty to affect many entities across all jurisdictions, the staff thinks that it is necessary to provide additional guidance in the final Standard. Failing to do so is likely to cause confusion and result in inconsistent application of the final Standard. This will reduce the comparability and reliability of financial statements. [*Sentence omitted from observer notes*] Therefore, the staff recommends that any final Standard includes additional guidance on how to address element uncertainty and that Board considers the alternative options analysed in section two of this paper.

15. **Does the Board agree?**

Alternative options for addressing element uncertainty

16. In this section the staff has evaluated the relative merits of five different options which may form the basis of additional guidance addressing element uncertainty:

    1. Reflect element uncertainty in measurement

    2. Reinstate the 'more likely than not' guidance in paragraphs 15 and 16 of the current IAS 37

    3. Reinstate the current probability recognition criterion

    4. Provide a list of indicators to act as guidance in determining whether a present obligation exists

    5. Identify an alternate obligating event

Option 1: Reflect element uncertainty in measurement

17. Under the first option, uncertainty about whether an item is a liability is reflected in the measurement of that item. Hence, the uncertain item is recognised if it can be measured reliably. (Note, the staff is not addressing the

degree of certainty required to achieve 'reliable measurement' in this paper[4].) To illustrate the application of option 1, consider the following simple example:

> Entity Z has identified a possible obligation but is not certain that a present obligation exists. At the balance sheet date Entity Z considers there to be a 50% likelihood that the possible obligation is not a present obligation and therefore that there is no potential outflow of economic resources. Entity Z considers there to be a 50% likelihood that the possible obligation is a present obligation and that a future outflow of $100,000 is expected. Applying option 1, Entity Z will recognise a liability at the balance sheet date based on the expected cash flow of $50,000[5].

18. The staff thinks that option 1 merits consideration because it enables an entity to reflect changes in the degree of uncertainty associated with a particular transaction or event from one period to the next. That is to say, the availability of known facts and circumstances may develop over time. These new facts and circumstances may not be sufficient to eliminate uncertainty, but they do provide additional information which may change an entity's assessment of the degree of uncertainty associated with the transaction or event. Option 1 enables this change to be reflected in the balance sheet. Consider the following example:

> **As at 31 December 20X6:**
>
> Entity A has received one complaint alleging product mis-selling. The allegation is being investigated by the regulatory authority, but the likely outcome of the investigation remains unclear at the reporting date. In the worst case scenario, Entity A will be fined $20,000 (assuming that Entity A has no obligation for damages). Entity A has assessed the risk of a present obligation as a result of product mis-selling to be low (10%). This assessment is based on Entity A's confidence in its internal control procedures and the existence of just one isolated complaint. Therefore, as at 31 December 20X6 Entity A recognises a liability based on the expected cash flow of $2,000[6].
>
> **As at 30 June 20X7:**
>
> The facts and circumstances described above remain unchanged, except Entity A has received an additional five complaints identical to the first complaint. These complaints are also being investigated by the regulatory authority, but the likely outcome of the investigation relating to all six complaints remains unclear at the reporting date. Additionally, an internal audit review conducted in May 20X7 has identified gaps in the training provided to the sales team, although it has not been confirmed that these gaps resulted in product mis-selling. Consequently, Entity A's assessment of the risk of a present obligation existing as a result of product mis-selling has

[4] What constitutes reliable measurement is a topic scheduled for discussion at the October 2006 Board meeting.
[5] ($100,000 * 50%) + ($nil * 50%) = $50,000.
[6] ($20,000 * 10%) + ($nil * 90%) = $2,000.

increased to 25%. Therefore, as at 30 June 20X7 Entity A increases its reported liability by $28,000 to $30,000[7].

19. [*Paragraph omitted from observer notes*]

20. [*Paragraph omitted from observer notes*]

21. [*Paragraph omitted from observer notes*]

Option 2: Reinstate the 'more likely than not' guidance in paragraphs 15 & 16 of the current IAS 37

22. The second option the staff would like to consider is reinstating the 'more likely than not' approach to determining whether a present obligation exists, currently included in paragraphs 15 and 16 of the IAS 37. Before discussing the relative merits of option 2 the staff emphasises that option 2 proposes using 'more likely than not' to determine the *existence* of a present obligation. Option 2 does *not* consider the probability of future economic outflows.

23. Option 2 is a direct contrast to option 1 because it requires an entity to address the question of whether a liability exists before considering recognition or measurement. Applying option 2 to the example of alleged product mis-selling above: at both 31 December 20X6 and 30 June 20X7 Entity A would conclude that no present obligation exists because neither the regulatory investigation nor its internal assessment indicate that it is more likely than not that the alleged product mis-selling occurred.

24. [*Paragraph omitted from observer notes*]

25. [*Paragraph omitted from observer notes*]

26. [*Paragraph omitted from observer notes*]

Option 3: Reinstate the current probability recognition criterion

27. Option 3 adopts a recognition based approach to addressing element uncertainty by using probability ('more likely than not') to determine whether a present obligation exists. However, unlike option 2, option 3 focuses on the probability of a future economic outflow *not* the probability that a present obligation exists. Therefore applying option 3 to the example of alleged product mis-selling above: at both 31 December 20X0 and 30 June 20X1, Entity A would conclude that no present obligation exists because neither the regulatory investigation nor its internal assessment indicate that it is probable a fine will be imposed.

28. [*Paragraph omitted from observer notes*]

Option 4: Provide a list of indicators to act as guidance

29. Like option 2, option 4 focuses on determining whether a present obligation exists. But option 4 does not use probability based guidance to address element uncertainty. Instead, option 4 is based on the approach adopted in the

[7] ($20,000 * 25%) + ($nil * 75%) = $5,000. Six complaints * $5,000 = $30,000.

UK Statement of Principles (refer to appendix A) that provides a list of indicators to assist an entity in determining whether a present obligation exists. Examples of indicators to be considered may include past experience with similar items, the experience of other entities, independent professional advice, management's willingness to sacrifice economic benefits to resolve any potential situation[8], the availability of known and verifiable facts, the existence of explicit reference material (eg contracts, laws, published policies and procedures), and context (eg geographic location, social and political environments).

30. The difference between options 2 and 4 can be illustrated by applying both options to the alleged product mis-selling example used above. Applying option 4 at 31 December 20X0, Entity A is likely to conclude that no present obligation exists because it has confidence in its internal control procedures and has received just one isolated complaint (the same outcome as option 2). At 30 June 20X1 Entity A may continue to conclude that, on the balance of evidence available, no present obligation exists (the same outcome as option 2). But, Entity A may also conclude that the weakness identified in its sales training is sufficient to conclude that a present obligation does exist. In which case Entity A will recognise a liability in its balance sheet as at 30 June 20X1.

31. [*Paragraph omitted from observer notes*]

Option 5: Identify an alternate obligating event

32. Option 5 removes the issue of element uncertainty by linking the existence of a liability to the conditional obligation rather than the unconditional obligation. Proponents of option 5 argue that many conditional obligations exist. But no present obligation exists for financial reporting purposes until the conditional obligation becomes unconditional. Applying option 5 to the example of alleged product mis-selling above: until the regulatory investigation is complete and a fine is imposed, Entity has no present obligation.

33. Proponents of option 5 would continue to conclude that no present obligation exists even if Entity A's internal investigation confirms that the alleged product mis-selling did occur. This is because knowledge of wrong doing creates a moral obligation. But moral obligations are not present obligations for financial reporting purposes because they cannot be enforced by a court (or equivalent). Therefore unless Entity A obligates itself (thereby creating a constructive obligation) before the regulatory investigation is complete and a fine is imposed, no present obligation exists.

34. [*Paragraph omitted from observer notes*]

35. [*Paragraph omitted from observer notes*]

36. [*Paragraph omitted from observer notes*]

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[8] Although intent to settle would not in itself be sufficient evidence to justify the existence of a present obligation, consistent with the ED's guidance on constructive obligations.

Conclusions

37. Based on the relative merits of each option assessed above, the staff recommends that any additional guidance addressing element uncertainty included in a final Standard should take the form of a list of indicators to assist an entity in determining whether a liability exists (option 4).

38. Does the Board agree?

[*Appendix A omitted from observer notes*]