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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting: **20 July 2007, London**

Project: **Liabilities - amendments to IAS 37**

Subject: **IAS 37 Redeliberations: uncertainty about the existence of a present obligation (Agenda paper 10B)**

INTRODUCTION

1. This paper summarises the Board's previous discussions on uncertainty about the existence of a present obligation, the feedback received at the IAS 37 round-tables and the outcome of subsequent work.

2. The paper divides into five sections:

   A. Re-capping previous discussions

   B. When does uncertainty about the existence of a present obligation arise?

   C. Draft indicators

   D. Do we need a 'more likely than not' criterion?

   E. Limitations of the proposed approach

3. In previous papers the staff used the phrase "element uncertainty" as shorthand for uncertainty about the existence of a present obligation. The staff has become aware that this shorthand sometimes causes confusion because "element" refers to the whole liability definition; the existence of a present obligation is just one part of that definition. Consequently, the staff does *not* use the phrase "element uncertainty" as shorthand in this paper.

A. RE-CAPPING PREVIOUS DISCUSSIONS[1]

4. IAS 37 considers uncertainty about the existence of a present obligation to be rare and therefore provides limited guidance. Paragraph 15 states: "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" (emphasis added).

5. The ED provides even less guidance, stating only that an entity must determine whether a present obligation exists after considering all of the available evidence. In other words, the 'more likely than not' criterion in paragraph 15 of the IAS 37 was not carried forward in the ED.

Tentative conclusions to date

6. In May 2006 the Board agreed to provide additional guidance on how to address uncertainty about the existence of a present obligation in any final standard, responding to concerns expressed by constituents in their comment letters. In reaching this conclusion the Board noted that uncertainty about the existence of a present obligation arises with sufficient frequency across all industries and jurisdictions to justify providing additional guidance.

7. After considering the relative merits of several approaches to addressing uncertainty about the existence of a present obligation, the Board directed the staff

[1] For more detail see agenda paper 10C discussed in May 2006, section A of the background materials for the IAS 37 round-tables and agenda papers 4A and 4B discussed in January 2007.

to develop indicators. For example, past experience with similar items, the experience of other entities with similar items, independent professional advice on the application of available reference materials and context (ie an entity's geographical location and the social and political environment).

8. However, the Board observed that indicators alone may not provide sufficient guidance to ensure consistent application. The Board therefore agreed to consider retaining the 'more likely than not' criterion currently in IAS 37. In making this observation, the Board emphasised that, in the context of discussing this issue, it would consider using a 'more likely than not' criterion to determine whether a present obligation *exists*, not whether a liability should be *recognised.* (Paragraph 14(b) of IAS 37 also uses 'more likely than not' as a recognition criterion. The ED proposes eliminating that criterion because the criterion causes an entity to omit from its balance sheet some present obligations that satisfy the definition of a liability, for example guarantees.)

Feedback received

9. At the IAS 37 round-tables and other consultative meetings most constituents supported the Board's intention to provide additional guidance on how to address uncertainty about the existence of a present obligation. However, the Board received a mixed response to its proposal to develop indicators in preference to re-instating a 'more likely than not' criterion.

10. Approximately half of the round-table participants favoured indicators, arguing that a 'more likely than not' criterion imposes an artificial bright-line that might cause entities to dismiss items that are, in fact, present obligations. At the same time, these participants acknowledged the challenge of drafting indicators capable of international application by all industries. For this reason a majority favoured high-level indicators (like those suggested in paragraph 7), although a few favoured industry-specific indicators or more illustrative examples.

11. Approximately half of the round-table participants, especially in London, favoured retaining a 'more likely than not' criterion. They argued that a 'more likely than not' criterion promotes consistency by providing a clear benchmark against which preparers and auditors can assess each item. Also, a 'more likely than not' criterion can be applied internationally because it is industry and geography neutral. Supporters of a 'more likely than not' criterion also noted that indicators could be perceived as a checklist of rules and inappropriately used to override management judgment.

12. After considering this feedback, the Board confirmed its intention to provide more guidance on how to address uncertainty about the existence of a present obligation and directed the staff to:

- clarify when uncertainty about the existence of a present obligation arises;
- draft high-level indicators for discussion; and
- evaluate the need for an explicit 'more likely than not' threshold in light of those draft indicators.

B. WHEN DOES UNCERTAINTY ABOUT THE EXISTENCE OF A PRESENT OBLIGATION ARISE?

13. In May 2006, the Board identified three general situations when uncertainty about the existence of a present obligation might arise.

(a) *Did a past event occur?* For example, before the balance sheet date an allegation of product mis-selling might be made against a regulated financial services organisation. If this allegation is correct, there is no doubt that the financial services organisation breached industry regulations. However, on the balance sheet date, the organisation might dispute the facts relating to the alleged product mis-selling. In this example, there is no uncertainty about how industry regulations apply to instances of product mis-selling, but there is uncertainty about whether the financial services organisation did breach those regulations.

(b) *How does authoritative guidance (including statute, law, contract and regulation) apply to known facts?* For example, before the balance sheet date an allegation of breach of contract might be made against an entity. If this allegation is correct, there is no doubt that the entity breached its contract with the external party. On the balance sheet date, the entity company does not dispute the fact that it took particular actions. However, the entity might dispute that its actions were outside the terms and conditions of the contract. In this example, there is no uncertainty about the facts, but there is uncertainty about how the terms and conditions of the contract apply to the actions in question.

(c) *In the absence of legal enforceability, do cumulative events and circumstances provide sufficient evidence to confirm that a present obligation exists?* For example, a mining company operating in a jurisdiction with no environment rehabilitation laws might publicly announce its intention to restore each site when it ceases mining. But in the absence of any other information, is a public statement of intent sufficient to confirm the existence of a present obligation?

14. The Board also observed that there is an important difference between uncertainty about the existence of a present obligation and uncertainty about the outflow of economic benefits required to settle a present obligation.

15. For example, in situation (b), after reviewing the terms and conditions of the contract, the entity might conclude that its past actions were, in fact, a breach of contract. In this situation, there is no uncertainty about the existence of a present obligation. However, the entity might then dispute the amount of damages it should pay as a result of breaching that contract. This second dispute illustrates uncertainty about the outflow of economic benefits required to settle the present

obligation. The entity would reflect uncertainty about the outflow of economic benefits required to settle its present obligation in measurement.

Staff comment

16. The staff believes that we have correctly identified the situations when uncertainty about the existence of a present obligation might arise. The staff reached this conclusion after considering the outcome of consultative meetings with a number of different groups, reviewing the material of other national standard setters and the information provided by the GC100 Group in a recent Board education session.

Outcome of consultative meetings[2]

17. The background materials used for the IAS 37 round-tables focused only on situations (a) and (b) described in paragraph 13. Several round-table participants observed that both of these situations describe uncertainty about the existence of a *legal* obligation. Almost all participants agreed that lawsuits (and disputes more generally) are particularly problematic because they combine uncertainty about the existence of a present obligation and uncertainty about the outflow of economic benefits required to settle a present obligation.

18. Other than the comments noted above, the staff received little direct feedback on situations (a) and (b) during the round-tables and other consultative meetings. This implies that participants generally agreed that the Board correctly identified and described these situations as examples of uncertainty about the existence of a present obligation might arise.

19. However, some of round-table participants, especially those in London, were concerned that the Board was excluding uncertainty about the existence of a *constructive* obligation from its discussions, ie those items captured by situation

[2] Between August 2006 and March 2007 the staff discussed uncertainty about the existence of a present obligation (and other topics) at the IAS 37 round-tables and during several consultative meetings. In total, the staff received feedback from 100+ organisations (including preparers, auditors, analysts and auditors) from 12+ countries.

(c). These comments indicate that participants agree that situation (c) is also an example of uncertainty about the existence of a present obligation.

Material of other standard setters

20. Several national standard setters acknowledge uncertainty about the existence of a present obligation in their conceptual framework or in other literature. For example the UK ASB explains "To recognise an item it is necessary to have sufficient evidence, both in amount and quality, that the item exists and is an asset or liability of the reporting entity …. What constitutes sufficient evidence is a matter of judgment in the particular circumstances of each case …"[3]

21. Most then go on to describe or give examples of uncertainty about the existence of a constructive obligation (situation (c)). For example, the Australian ASB notes that "in the absence of a clear legal responsibility, the existence of a present obligation is a matter for determination from the evidence available".[4] And the FASB notes "the line between equitable or constructive obligations and no obligations may often be even more troublesome because to determine whether an entity is actually bound by an obligation to a third party in the absence of legal enforceability is often extremely difficult."[5]

22. The staff has identified only limited discussion about disputes (situations (a) and (b)). Although the staff has found no material that contradicts the Board's previous observations.

Information provided by the GC100 Group

23. The staff believes that the information provided by the GC100 Group in April 2007 indicates that the Board has correctly identified and described situations in which uncertainty about the existence of a legal obligation might arise (situations (a) and (b)). For example, the GC100 Group's response to the question "what

[3] *Statement of Principles of Financial Reporting*, paragraphs 5.14-5.15
[4] SAC 4 *Definition and Recognition of Elements of Financial Statements*, paragraph 58
[5] Concepts Statement No. 6 *Elements of Financial Statements*, paragraph 40

factors do legal teams consider in determining whether an entity has a case to answer and therefore a present obligations exists" included the following[6]:

- What are the facts?
- What is the relevant governing law or laws and what is the court or tribunal with jurisdiction?
- How clear is the law in relation to these facts, to the extent identifiable? Doubts as to the law on precise facts frequently exist. Even if case law suggests the law will operate in a particular way, what are the differentiations between the circumstances of those cases and the current case? It is frequently the position that there is no decided case law exactly on point or that the law is not clear.

Is the Board satisfied that we have correctly identified the general situations when uncertainty about the existence of a present obligation might arise?

C. DRAFT INDICATORS

24. This section of the paper suggests indicators to address uncertainty about the existence of a present obligation in situations (a) and (b) only. Agenda paper 10C discusses constructive obligations (situation (c)).

Framing the indicators

25. As noted in paragraph 11, some constituents are concerned that indicators might be inappropriately perceived as a checklist of rules. The staff agrees. In suggesting indicators as an option, the staff's aim is to provide preparers and auditors with parameters within which to exercise their judgement, not to provide a definitive answer to uncertainty about the existence of a present obligation. The staff proposes framing any indicators in the context of a statement to this effect.

[6] For the GC100 Group's complete response, see slides 11 and 12 in agenda paper 8A presented at the April 2007 Board meeting.

26. The staff notes that its proposal is consistent with the way indicators are framed in other IFRS literature. Appendix A provides examples. The staff therefore recommends framing any indicators in IAS 37 using something along the lines of the following text:

> The evidence described in paragraph [xx] is not an exhaustive list. Where appropriate, an entity should consider any other relevant evidence before concluding that a present obligation does or does not exist. Equally, the evidence described in paragraph [xx] should not be used as a list of minimum conditions that must be satisfied before an entity concludes that a present obligation exists.

Does the Board agree?

Content

27. The staff has identified a number of possible indicators to address uncertainty about the existence of a present obligation. The staff identified possible indicators by reviewing the suggestions made during consultative meetings and the indicators used in other IFRSs and by national standard-setters (appendix B provides examples). In assessing each possible indicator for inclusion in any final standard, the staff considered the following:

- Is the possible indicator geography and industry neutral?
- Is the possible indicator consistent with the description of a present obligation in the *Framework*?
- Is the possible indicator consistent with the Board's tentative conclusions in this project and other related projects?
- Is the possible indicator consistent with the way management would assess each item?
- Could preparers use the possible indicator without incurring significant additional costs?

28. Invariably, considering each of these questions and then deciding whether to include a possible indicator in any final standard requires judgement. Moreover, as noted above, this list is not exhaustive. The table below summarises the staff's conclusions and briefly explains the rationale underpinning each conclusion.

Possible indicator	**Staff comment**	**Include?**
The entity's past experience with similar items.	The staff believes that, on balance, this possible indicator satisfies the questions above.	Yes
The experience of other entities with similar items.	The staff questioned whether this possible indicator is feasible. This is because an entity is unlikely to have full knowledge of other entities' experience with similar items. Moreover, even if that information were publicly available, the cost of evaluating that information might outweigh the benefits. However, the staff understands that most public organisations have in place some systems to ensure that management remain aware of industry developments and of the activities of its main competitors. Therefore, in some situations, management will be able to use the experience of others.	Yes
The opinion of experts.	The staff notes that some constituents are concerned about the costs associated with obtaining the advice and opinion of experts. However, the staff notes that indicators are not intended to be an exhaustive list of conditions to be satisfied before concluding that a present obligation does or does not exist. In addition, the staff understands that, if a potential present obligation is material, management is already likely to seek expert advice. Moreover, the staff does not propose limiting this possible indicator to 'the opinion of *independent* experts' because this might be read to imply that an entity cannot use internal expertise (although both management and auditors may need to assess the objectivity of internal expert advice).	Yes

Possible indicator	Staff comment	Include?
Context - ie an entity's geographical location and the social and political environment.	The staff does not propose including this indicator in any final standard. This is because 'social and political environment' could be read to admit items that the Board has tentatively concluded do not demonstrate the essential characteristics of a present obligation in its Conceptual Framework project, for example, moral and equitable obligations. (Although the staff acknowledges that, in some circumstances, the existing IASB *Framework* might admit such items as present obligations.)	No
Additional evidence provided by events after the balance sheet date about conditions that existed on the balance sheet date.	The staff believes that, on balance, this possible indicator satisfies all of the above questions. It is also consistent with the guidance already in IAS 37, the IAS 37 ED and IAS 10 *Events After the Balance Sheet Date*. Note that the additional information must relate to conditions existing on the balance sheet date.	Yes
Any evidence of a potential breakdown or weakness in an entity's internal controls – for example, a letter of complaint or the start of legal proceedings or an internal audit report.	The staff believes that, on balance, this possible indicator satisfies all of the above questions.	Yes
External detection or a history of external detection.	The staff does not propose including this possible indicator in any final standard because it contradicts an earlier tentative conclusion in this project. Namely that the likelihood that an external party will detect an entity's violation of the law or breach of contract is not relevant in determining whether the definition of a liability is satisfied (but it would affect the measurement of the liability).[7]	No
Expected future cash outflows.	The staff does not propose including this possible indicator in any final standard because expected future cash flows relate to the amount required to settle a present obligation, not the existence of a present obligation (see paragraphs 14 and 15). However, the staff acknowledges that a post-balance sheet cash outflow may provide evidence that a present obligation existed before the balance sheet date.	No

[7] Agenda Paper 3B, June 2006.

Does the Board agree with the staff's assessment of possible indicators?

Are there any other indicators the Board would like to include in any final standard?

Level of detail

29. As noted in paragraph 12, the Board directed the staff to develop high-level, rather than industry-specific, indicators. This direction is consistent with the indicators used in other IFRSs and by national standard-setters (see appendix B).

30. However, varying degrees of detail are still available to the Board. The staff has therefore considered two levels of detail. Text 1 provides minimal detail, identifying the proposed indicators only and is similar to the level of detail provided in the UK ASB *Statement of Principles for Financial Reporting* and the FASAB[8] Exposure Draft on *Definition and Recognition of Elements of Accrual-Basis Financial Statements*, for example. Text 2 identifies the same indicators, but also explains how an entity might use each indicator. Text 2 is similar to the level of detail provided in SIC 12 *Consolidation – Special Purpose Entities* (indicators of control over an SPE) and the Exposure Draft of Proposed Amendments to IFRS 3 *Business Combinations* (whether payment for employee services should be accounted for as part of the exchange), for example.

Text 1

After considering all available evidence, an entity must use judgment to determine whether a present obligation exists. The evidence an entity considers and the relative weight assigned to each piece of evidence will depend on the individual facts and circumstances of each case, but might include:

(a) the entity's own experience with identical or similar items;

(b) the experience of others with identical or similar items;

(c) the opinion of experts;

[8] US Federal Accounting Standards Advisory Board

(d) additional evidence provided by events after the balance sheet date about conditions that existed on the balance sheet date;

(e) any evidence of a potential breakdown or weakness in an entity's internal controls (for example a letter of complaint, the start of legal proceedings or an internal audit report).

Text 2

After considering all available evidence, an entity must use judgment to determine whether a present obligation exists. The evidence an entity considers and the relative weight assigned to each piece of evidence will depend on the individual facts and circumstances of each case, but might include:

(a) the entity's own experience with identical or similar items. For example, a financial services organisation with a past record of product mis-selling (a breach of industry regulations) is more likely to conclude that alleged but not confirmed claims of product mis-selling have foundation (and therefore a present obligation exists) than a financial services organisation with an exemplary past record.

(b) the experience of others with identical or similar items. For example, an airline company is more likely to conclude that its past practices breached industry regulations (and therefore a present obligation exists) after a court or regulatory body rules against one of its competitors that used identical practices.

(c) the opinion of experts. For example, an entity is more likely to conclude that its past actions breached the terms and conditions of a contract when legal advice indicates that, even thought the wording in the contract is unclear, precedent established by case law favours the plaintiff.

(d) additional evidence provided by events after the balance sheet date about conditions that existed on the balance sheet date. For example, on the balance sheet date, a catering company may supply seemingly good quality food to a client. However, large numbers of reported food poisoning one day later may indicate that the catering company did not provide good quality food, and a present obligation exists.

(e) any evidence of a potential breakdown or weakness in an entity's internal controls (for example a letter of complaint, the start of legal proceedings or an internal audit report). For example, the catering company above is more likely to conclude that it did not provide good quality food, and a present obligation exists if an internal audit investigation reports a break down in food hygiene procedures on the day of the function.

31. The staff prefers Text 1. In the staff's view the extra detail included in Text 2 simply states the obvious and, as a result, is unlikely to be of any practical use to preparers and auditors. Moreover, because IAS 37 is a general standard

about liabilities (whereas some of the indicators used in other standards address more specific topics), including more detail could become too prescriptive.

32. However, the staff also proposes incorporating the Board's thinking on this issue (as described in paragraphs 13-15, 28 and text 2 in paragraph 30) in the application guidance accompanying any final standard. The staff believes that this thinking would be useful in helping preparers and auditors understand the Board's logic and would promote consistent application.

Does the Board agree?

D. DO WE NEED A 'MORE LIKELY THAN NOT' CRITERION?

Arguments against

33. In many respects, the staff questions the value of including an explicit 'more likely than not' criterion in any final standard. Specifically:

(a) in Section C of this paper the staff proposes acknowledging the limitations of indicators and emphasising the need to use judgement. Judgement invariably involves assessing all available evidence on the balance sheet date before concluding that a present obligation does or does not exist. In effect, this assessment is an *implicit* 'more likely than not' criterion.

(b) an *explicit* 'more likely than not' criterion does not always accompany the indicators used in other IFRSs and by national standard setters (see appendix B).

(c) there is a risk that using a 'more likely than not' criterion to address uncertainty about the existence of a present obligation could be mis-applied. In other words, an entity might use the likelihood that a future outflow of economic benefits will be required to settle the item in question used to determine whether a present obligation exists.

(d) including a ‘more likely than not’ criterion may create asymmetry with the proposed guidance on derecognition in the ED.[9] (Although, of course, the Board could choose to align the derecognition guidance in the ED with its conclusion on a ‘more likely than not’ criterion.)

Arguments in favour

34. The staff acknowledges the arguments of those constituents who favour using a ‘more likely than not’ criterion to address uncertainty about the existence of a present obligation (see paragraph 11). In particular, the staff agrees that a ‘more likely than not’ criterion is a clearer benchmark against which preparers and auditors can assess each item. A clearer benchmark is likely to promote more consistent application. Additionally:

(a) after speaking with Board members with English as their second language, the staff understands that an explicit criterion may help to resolve some application differences that arise from the approach taken to addressing uncertainty in national GAAP. For example, a ‘more likely than not’ criterion provides a common benchmark for entities coming from a more conservative, tax-based environment that previously required an entity to recognise the maximum potential exposure *and* for entities coming from a less conservative environment that required an entity to recognise the minimum potential exposure.

(b) other standard setters have recently accepted a ‘more likely than not’ criterion as a practical expedient for addressing uncertainty in other standards-level projects and interpretations. For example, the FASB recently included a ‘more likely than not’ criterion in FIN 48 *Accounting for Uncertainty in Income Taxes*.[10]

[9] IAS 37 ED, paragraph 51: “An entity shall derecognise a non-financial liability when the obligation is settled, cancelled or expires”.

[10] FIN 48, paragraph 6: “An enterprise shall initially recognize the financial statement effects of a tax position when it is more likely than not, based on the technical merits, that the position will be sustained upon examination. .... The more-likely-than-not recognition threshold is a positive assertion that an enterprise believes it is entitled to the economic benefits associated with a tax position. The determination of whether or not a tax position has met the more-likely-than-not recognition threshold shall consider the facts, circumstances, and information available at the reporting date.”

(c) failing to include an explicit 'more likely than not' criterion raises challenging questions about how much evidence an entity needs to consider before it can reasonably assess that the balance of evidence available indicates that a present obligation exists.

35. The staff also considers that the risk of a 'more likely than not' criterion being mis-applied to the outflow of economic benefits required to settle an item could be overcome by identifying the situations in which uncertainty about the existence of a present obligation might arise (section B) to emphasise that any indicators may only be applied to the present obligation. For example, the text in any final standard could read something along the lines of:

> In most situations there is little doubt that a present obligation exists. However in some situations, such as disputes, there may be uncertainty about the existence of a present obligation. For example, there may be uncertainty about whether an alleged past event occurred. Alternatively, there may be uncertainty about whether a law applies to known facts.

The FASB used a similar approach when redeliberating the recognition and measurement of contingencies in Business Combinations Phase II.[11]

Staff comment

36. Ideally, the staff would prefer *not* to include an explicit 'more likely than not' criterion in any final standard. However, the staff accepts that an explicit criterion is a clearer benchmark that is likely to promote more consistent application.

37. Therefore, on balance, the staff recommends including an explicit 'more likely than not' criterion in a final standard. However, the staff proposes clearly stating in the Basis for Conclusions that recommendation is a practical expedient to promote consistent application, and does not set a precedent for future projects.

Does the Board agree?

[11] The tentative wording used on the FASB website is that an entity should "recognise all contingences arising from contractual rights and obligations" and "recognise contingencies that do not arise from contractual rights and obligations on the first date that it is more likely than not the contingency meets the definition of an asset or a liability."

E. LIMITATIONS OF THE PROPOSED APPROACH

38. The staff think that the approach outlined in sections C and D takes a pragmatic approach to addressing uncertainty about the existence of a present obligation. However, the staff acknowledges that this approach is not perfect. This section of the paper seeks to draw the Board's attention to the limitations of this approach. We are not asking the Board to overcome these limitations at this meeting or as part of this project.

Potential tension with other projects

39. The staff is also concerned that the approach outlined in sections C and D may set an unintended precedent for the Revenue Recognition project.

40. The hamburger example previously discussed by the Board illustrates the staff's concerns. To re-cap, the key facts in the hamburger example are:

- on the balance sheet date Vendor sold one hamburger in a jurisdiction where the law states that the vendor must pay compensation of £100,000 to each customer that purchases a contaminated hamburger.

- past experience indicates that one in a million hamburgers sold by the entity are contaminated. No other information is available.

41. At a very simplistic level, from a revenue recognition perspective we *could* analyse the Vendor's obligations in this example as follows:

    (a) on the balance sheet date, Vendor and Customer entered into a contract whereby Vendor explicitly agreed to supply Customer with a hamburger in return for £*x*. Because Vendor operates in a jurisdiction subject to particular laws, Vendor also implicitly agreed to supply Customer with a hamburger that is fit for consumption, or pay compensation.

    (b) Customer has paid Vendor £*x*. As a result, Vendor recognises an unconditional performance obligation to supply Customer with one hamburger.

(c) on the balance sheet date, Vendor supplies one hamburger to Customer.

(d) the best-case scenario is that Vendor supplied a good quality hamburger. He has fulfilled his performance obligation and therefore does not have a present obligation to pay compensation to Customer.

(e) the worst-case scenario is that Vendor sold a contaminated hamburger. He has not fulfilled his performance obligation and therefore has a present obligation to pay compensation to Customer.

(f) based on the facts in this example, there is a one in a million chance that Vendor has *not* yet fulfilled his performance obligation. Therefore, a present obligation continues to exist on the balance sheet date.

42. In the short term, the staff proposes avoiding this *potential* tension by using other examples that do not involve a revenue transaction to illustrate uncertainty about the existence of a present obligation (like those in section B).

Potential application issues

43. The staff thinks that approach to addressing uncertainty about the existence of a present obligation outlined in sections C and D raises some challenging application issues. Examples include:

(a) is it reasonable for an entity to assess that a present obligation exists for a portfolio of similar items even though, on an individual basis, the balance of evidence available does not indicate that a present obligation exists? For example, in the hamburger example does Vendor need to sell one million hamburgers before he can use past experience to conclude that it is ‘more likely than not’ that a present obligation exists?

(b) having assessed that the balance of evidence available indicates that a present obligation and a liability exists, does an entity ignore or incorporate the possibility that a present obligation may not exist when measuring the liability?

Staff comment

44. Despite these limitations, the staff thinks that the approach outlined in this paper is a pragmatic approach to addressing uncertainty about the existence of a present obligation. The staff therefore asks the Board to reach a tentative conclusion so that we can move on and start considering some of the other issues in this project, particularly recognition and measurement. In particular, the staff notes that:

(a) given the nature of the topic (uncertainty), the Board could invest a significant amount of time striving to find a "perfect" answer that does not exist;

(b) the Revenue Recognition project is still at an early stage – the potential tension described above may not even arise. Delaying progress in the IAS 37 project because of concerns about *potential* tensions with the Revenue Recognition project is likely to prevent the Board issuing a final standard that includes several other improvements to the way we account for liabilities within the scope of IAS 37.

(c) reaching a tentative conclusion about how to address uncertainty about the existence of a present obligation now would not prevent the Board from circling back to this issue if new thinking comes to light.

(d) in the staff's opinion, one of the most important proposals coming out of this project is emphasising that uncertainty about the amount to settle a present obligation is reflected in measurement and does not preclude an entity concluding that a liability exists. The approach outlined in this paper does not detract from that proposal.

Does the Board agree?

APPENDIX A: Examples of framing indicators

Source	Text used to frame indicators
SIC-12 *Consolidation – Special Purpose Entities*, Appendix A	The guidance provided in the Interpretation and in this Appendix is not intended to be used as a 'comprehensive checklist' of conditions that must be met cumulatively in order to require consolidation of an SPE.
IAS 36 *Impairment of Assets*, paragraph 13	The list [of indicators] in paragraph 12 is not exhaustive. An entity may identify other indications that an asset may be impaired and these would also require the entity to determine the asset's recoverable amount, or in the case of goodwill, perform an impairment test …
Exposure Draft of Proposed Amendments to IAS 24 *Related Party Disclosures*, paragraph 17D	The indicators of influence described in paragraphs 17B and 17C are not exhaustive. A reporting entity might identify other factors or circumstances that suggest the reporting entity could influence, or be influenced by, the related party that would require the reporting entity to comply with the [disclosure] requirements …

APPENDIX B: Examples of indicators used in other literature

This appendix provides selected examples of indicators used in other IFRSs and in the literature of national standard setters. It is not a comprehensive list of all examples of indicators. The staff selected these indicators to provide the Board with an idea of the varying level of detail available.

Reference	Indicators
IAS 36 *Impairment of assets*, paragraph 12	In assessing whether there is any indication that an asset may be impaired, an entity shall consider, as a minimum, the following indications: External sources of information a) during the period, an asset's market value has declined significantly more than would be expected as a result of the passage of time or normal use. b) significant changes with an adverse effect on the entity have taken place during the period, or will take place in the near future, in the technological, market, economic or legal environment in which the entity operates or in the market to which an asset is dedicated. c) market interest rates or other market rates of return on investments have increased during the period, and those increases are likely to affect the discount rate used in calculating an asset's value in use and decrease the asset's recoverable amount materially. d) the carrying amount of the net assets of the entity is more than its market capitalisation. Internal sources of information e) evidence is available of obsolescence or physical damage of an asset. f) significant changes with an adverse effect on the entity have taken place during the period, or are expected to take place in the near future, in the extent to which, or manner in which, an asset is used or is expected to be used. These changes include the asset becoming idle, plans to discontinue or restructure the operation to which an asset belongs, plans to dispose of an asset before the previously expected date, and reassessing the useful life of an asset as finite rather than indefinite. g) evidence is available from internal reporting that indicates that the economic performance of an asset is, or will be, worse than expected.
Exposure Draft of Proposed Amendments to IFRS 3 *Business Combinations,* paragraph A99	If it is not clear whether an arrangement to pay for employee services should be accounted for as part of the exchange for the acquiree or separately from the business combination, the following indicators also should be considered: a) *Continuing employment* - If future payments are automatically forfeited if employment ends, the arrangement may be compensation for post-combination services that will benefit the combined entity and should be accounted for separately from the business combination. In contrast, if future payments are not affected by employment termination, the arrangement may be part of the consideration transferred for the acquiree. b) *Duration of continuing employment* - An employment agreement with an employment period coinciding with or longer than the future payment

Reference	Indicators
	period may indicate that the arrangement is compensation for post-combination services that will benefit the combined entity and should be accounted for separately from the business combination accounting. c) *Level of payment* - Reduced payments to owners who do not become employees may indicate that the incremental payments to selling owners who become employees are payments for post-combination services that will benefit the combined entity and should be accounted for separately from the business combination accounting. In contrast, payments in excess of reasonable levels paid to employees with similar responsibilities may indicate that the payment is part of the consideration transferred for the acquiree. d) *Formula for determining consideration* - Contingent payments that are based on multiples of future earnings, future cash flows, or other similar performance measures may indicate that the formula is intended to verify the fair value of the acquiree and, therefore, should be accounted for as part of the business combination. In contrast, contingent payments based on percentages of earnings may indicate a profit-sharing arrangement that should be accounted for separately from the business combination.
Exposure Draft of Proposed Amendments to IAS 24 *Related Party Disclosures,* paragraph 17B	Indicators that the influence referred to in paragraph 17A(b) exists are when the related parties: a) transact business at non-market rates (otherwise than by way of regulation); b) share resources; or c) engage in economically significant transactions with each other.
SIC 12 *Consolidation – Special Purpose Entities,* Appendix A	(a) *Activities* The activities of the SPE, in substance, are being conducted on behalf of the reporting entity, which directly or indirectly created the SPE according to its specific business needs. Examples are: • the SPE is principally engaged in providing a source of long-term capital to an entity or funding to support an entity's ongoing major or central operations; or • the SPE provides a supply of goods or services that is consistent with an entity's ongoing major or central operations which, without the existence of the SPE, would have to be provided by the entity itself. Economic dependence of an entity on the reporting entity (such as relations of suppliers to a significant customer) does not, by itself, lead to control. (b) *Decision-making* The reporting entity, in substance, has the decision-making powers to control or to obtain control of the SPE or its assets, including certain decision-making powers coming into existence after the formation of the SPE. Such decision-making powers may have been delegated by establishing an 'autopilot' mechanism.

Reference	Indicators
	Examples are: • power to unilaterally dissolve an SPE; • power to change the SPE's charter or bylaws; or • power to veto proposed changes of the SPE's charter or bylaws. (c) *Benefits* The reporting entity, in substance, has rights to obtain a majority of the benefits of the SPE's activities through a statute, contract, agreement, or trust deed, or any other scheme, arrangement or device. Such rights to benefits in the SPE may be indicators of control when they are specified in favour of an entity that is engaged in transactions with an SPE and that entity stands to gain those benefits from the financial performance of the SPE. Examples are: • rights to a majority of any economic benefits distributed by an entity in the form of future net cash flows, earnings, net assets, or other economic benefits; or • rights to majority residual interests in scheduled residual distributions or in a liquidation of the SPE. (d) *Risks* An indication of control may be obtained by evaluating the risks of each party engaging in transactions with an SPE. Frequently, the reporting entity guarantees a return or credit protection directly or indirectly through the SPE to outside investors who provide substantially all of the capital to the SPE. As a result of the guarantee, the entity retains residual or ownership risks and the investors are, in substance, only lenders because their exposure to gains and losses is limited. Examples are: • the capital providers do not have a significant interest in the underlying net assets of the SPE; • the capital providers do not have rights to the future economic benefits of the SPE; • the capital providers are not substantively exposed to the inherent risks of the underlying net assets or operations of the SPE; or • in substance, the capital providers receive mainly consideration equivalent to a lender's return through a debt or equity interest.

Reference	**Indicators**
UK ASB, *Statement of Principles for Financial Reporting*, paragraphs 5.14-5.15	To recognise an item it is necessary to have sufficient evidence, both in amount and quality, that the item exists and is an asset or liability of the reporting entity. This is reflected in the first of the two criteria for initial recognition, which requires that sufficient evidence must exist that a new asset or liability has been created or that there has been an addition to an existing asset or liability. What constitutes sufficient evidence is a matter of judgement in the particular circumstances of each case although, while the evidence needs to be adequate, it need not be (and often cannot be) conclusive. The main source of evidence will be past or present experience with the item itself or with similar items, including: a) evidence provided by the event that has given rise to the possible asset or liability; b) past experience with similar items (for example, successful research and development in the past); c) current information directly relating to the possible asset or liability; and d) evidence provided by transactions of other entities in similar assets and liabilities.
FASAB Exposure Draft *Definition and Recognition of Elements of Accrual-Basis Financial Statements*, paragraph 36.	Although all federal liabilities have their foundation in law, some liabilities are construed from the totality of the conditions and facts of a particular situation, rather than from specific legal or regulatory requirements. In those circumstances, the government should weigh the totality of the facts of the situation against the definition and essential characteristics of liabilities (discussed in paragraphs 40 through 48) and make an informed judgment as to whether or when a liability has been incurred. Factors that may affect that conclusion include relevant aspects of the legal framework within which the government is constituted, whether the government has an agreement or understanding with another entity concerning the nature and amount of the government's obligation and the timing of settlement, and decisions or actions in previous situations that are relevant precedents.