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**International
Accounting Standards
Board**

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

INFORMATION FOR OBSERVERS

Board Meeting: 20 July 2007, London

Project: Liabilities - amendments to IAS 37

Subject: IAS 37 Redeliberations: constructive obligations
(Agenda paper 10C)

INTRODUCTION

1. This paper summarises the Board's previous discussions about constructive obligations, the feedback received and the outcome of subsequent work.
2. The paper divides into the following sections:
 - A. Re-capping previous discussions
 - B. Limit recognition of constructive obligations to those a court could enforce
 - C. Explain the meaning of 'by equivalent means'
 - D. Retain the proposals in the ED

- E. Comparative analysis
- F. Is there anything else we can do?

A. RE-CAPPING PREVIOUS DISCUSSIONS

The proposals¹

3. When developing the IAS 37 ED the Board was concerned that an entity might recognise items that do not satisfy the definition of a liability as a result of interpreting the definition of a constructive obligation too broadly. For example, the Board reasoned that simply announcing a restructuring plan does not satisfy the definition of a liability because an entity could subsequently recall the plan, thereby avoiding a future outflow of economic benefits.
4. The Board observed that the main issue associated with constructive obligations is what makes a constructive obligation an *obligation* in the absence of legal enforceability? – in other words, where is the line between an obligation and no obligation? However, the Board concluded that it would be inappropriate to definitively answer this question without reconsidering liabilities and constructive obligations more fundamentally.
5. In the meantime, the Board considered two ways to achieve greater consistency in the accounting for constructive obligations: (i) emphasise that a constructive obligation always involves an obligation to others, or (ii) limit the recognition of constructive obligations to those that a court could enforce. A majority of Board members favoured the first option. Therefore, the ED proposes inserting the phrase ‘reasonably rely on’ into the definition of a liability and inserting the following explanatory text:

15 In the absence of legal enforceability, particular care is required in determining whether an entity has a present obligation that it has little, if any, discretion to avoid settling. In the case of a constructive obligation, this will only be the case if:

¹ For more detail see IAS 37 ED, paragraphs BC 58-60 and BC 68.

- (a) the entity has indicated to other parties that it will accept particular responsibilities;
 - (b) the other parties can reasonably expect the entity to perform those responsibilities; and
 - (c) the other parties will either benefit from the entity’s performance or suffer harm from its non-performance.
6. Through the course of its discussions, the Board also observed that the separate definitions of legal and constructive obligations in IAS 37 today suggest that legal and constructive obligations are mutually exclusive. Sometimes this causes confusion because many items described as constructive obligations are legally enforceable. Indeed, in many jurisdictions ‘constructive’ is an accepted legal term.² The IAS 37 ED therefore also seeks to soften the dividing line between legal and constructive obligations by inserting the following text:

14 Because most liabilities arise from legal obligations, settlement can be enforced by a court. Some liabilities arise from constructive obligations, in which the obligation is created by, or inferred from, an entity’s past actions rather than arising from an explicit agreement with another party or from legislation. In some jurisdictions, constructive obligations may also be enforced by a court, for example, in accordance with the legal principle known in the United States as promissory estoppel³ or principles having the same effect under other legal systems.

Feedback received

‘Reasonably rely on’

7. In their comment letters, a majority of respondents agreed that a constructive obligation always involves an obligation to others and welcomed the new explanatory text proposed in the paragraph 15 of the ED. However, several also
 - commented that the explanatory text in paragraph 15 of the ED more effectively emphasises that a constructive obligation involves an

² *Black’s Law Dictionary* defines constructive as “legally imputed; having an effect in law though not necessarily in fact.”

³ *Black’s Law Dictionary* defines promissory estoppel as “the principle that a promise made without consideration may nonetheless be enforced to prevent injustice if the promisor should have reasonably expected the promisee to rely on the promise and if the promisee did actually rely on the promise.”

obligation to others than inserting the phrase ‘reasonably rely on’ into the definition of a constructive obligation.

- asked the Board to give examples of items previously described as constructive obligations that would no longer be recognised because they do not involve an obligation to others.
8. A few respondents challenged the Board’s decision not to limit the recognition of constructive obligations to those a court could enforce. They argued that this approach would improve consistency in practice and achieve greater convergence with US GAAP.

Softening the dividing line between legal and constructive obligations

9. Few respondents commented on the new explanatory text proposed in the paragraph 14 of the ED. Implicitly, a majority seemed to agree that many items described as constructive obligations are legally enforceable. However, some objected to the term ‘promissory estoppel’ because it is jurisdiction-specific.

Other

10. The Board received a summary of all others issues associated with the constructive obligations raised in the comment letters and a staff response to each issue in May 2007. This paper does not repeat that material.⁴

Subsequent discussions⁵

11. In May 2007 the Board reviewed its proposed amendments to constructive obligations in the light of the feedback received and its more recent discussions on how to distinguish a liability from a business risk. As a result of these discussions, the Board affirmed that:

⁴ See Appendix A to agenda paper 8 discussed by the Board in May 2007.

⁵ See agenda paper 8 discussed in May 2007. The Board discussed sections A-C only at that meeting.

- (a) the main issue associated with constructive obligation is: what makes a constructive obligation an *obligation* in the absence of legal enforceability?
- (b) many items described as constructive obligations are legally enforceable. This includes (but is not limited to) items captured by the doctrine of promissory estoppel, oral contracts, quasi contracts, legal precedent, case law, regulatory law and common law.⁶ Indeed, many of these items would be captured by the current definition of a legal obligation in IAS 37.
12. The Board also affirmed that answering the question identified in paragraph 11(a) is beyond the scope of this project. Therefore redeliberations will focus on achieving greater consistency in the accounting for constructive obligations and ensuring that any tentative conclusions are consistent with the tentative conclusions following redeliberations of other aspects of the ED. (Particularly the Board's tentative conclusions on distinguishing a liability from a business risk - see agenda paper 10A.) .
13. The Board therefore instructed the staff to explore three options:
- (1) limit the recognition of constructive obligations to those a court could enforce;
 - (2) recognise both constructive obligations that a court could enforce and constructive obligations that are enforceable 'by equivalent means' and explore the meaning of 'by equivalent means';

⁶ These terms are defined in <http://dictionary.law.com>:

- *oral contract*: 'an agreement made with spoken words and either no writing or only partially written. An oral contract is just as valid as a written agreement.'
- *quasi*: 'Latin for "as if," almost, somewhat, to a degree (always used in combination with another word). Quasi refers to things and actions which are not exactly or fully what they might appear, but have to be treated "as if" they were.'
- *legal precedent*: 'a prior reported opinion of an appeals court which establishes the legal rule (authority) in the future on the same legal questions decided in the prior judgment.'
- *case law*: 'reported decisions of appeals courts and other courts which make new interpretations of the law and, therefore, can be cited as precedents.'
- *regulatory law*: 'regulations required by agencies based on statutes'
- *common law*: 'the traditional unwritten law of England based on custom and usage.'

- (3) option 2, but use the explanatory text already in paragraph 15 of the ED as a proxy for explaining ‘by equivalent means’.

B. LIMIT RECOGNITION OF CONSTRUCTIVE OBLIGATIONS TO THOSE A COURT COULD ENFORCE (OPTION 1)

14. Option 1 seeks to achieve greater consistency in the accounting for constructive obligations by limiting the recognition to those that a court could enforce, including those items identified in paragraph 11(b). Option 1 is also consistent with the Board’s tentative conclusions on distinguishing a liability from a business risk because it limits the recognition of liabilities to situations when a court could enforce an external party’s right to call upon an entity to act in a particular way.
15. The Board could implement option 1 by either limiting the scope of any final standard, or inserting a legal enforceability recognition criterion.

Over-coming previous objections

Interaction with the Framework

16. As noted in paragraph 5, the Board debated option 1 before issuing the IAS 37 ED. At that time, one argument against this option was inconsistency with the *Framework*. This is because paragraph 60 of the *Framework* admits as obligations items arising from normal business practice, custom and a desire to maintain good business relations or to act in an equitable manner, as well as legally enforceable obligations.
17. The staff no longer thinks that inconsistency with the *Framework* can be used as an argument against option 1. This is because option 1 does not seek to limit the number of items that satisfy the *definition* of a constructive obligation. Rather, option 1 seeks to limit the *recognition* of items that satisfy the definition of a constructive obligation to those that court could enforce at a standards-level. This option is consistent with the approach taken by the FASB in FAS 143 *Accounting*

for Asset Retirement Obligations. (Although the staff notes that IAS 37 is a general standard that captures all liabilities not within the scope of another standard whereas FAS 143 considers asset retirement obligations only.)

18. Moreover, the staff agrees with those respondents who note that option 1 establishes a clear objective that is likely to achieve greater consistency in practice. The FASB reached the same conclusion when redeliberating FAS 143:

“... To achieve more consistent application of this Statement, the Board decided that only existing legal obligations, including legal obligations under the doctrine of promissory estoppel, should be included in the scope. Legal obligations, as used in this Statement, encompass legally enforceable obligations and constructive obligations, as those terms are used in Concepts Statement 6.”

Interaction with IAS 19

19. Another argument previously used against option 1 was the effect on accounting for items described as constructive obligations in IAS 19 *Employee Benefits*. IAS 19 currently uses the IAS 37 definition of a constructive obligation to explain the accounting for two types of employee benefits: (i) unvested benefits, and (ii) informal practices that leave the entity with little, if any, discretion to avoid paying employee benefits. The IAS 37 ED therefore proposes a number of consequential amendments to the appropriate paragraphs in IAS 19.
20. Regarding unvested benefits, the IAS 37 ED proposes deleting the word ‘constructive’ from IAS 19. In other words, the ED proposes that unvested benefits give rise to an obligation, not a constructive obligation. For example, the ED proposes amending paragraph 69 of IAS 19 to read:

69 Employee service gives rise to an obligation under a defined benefit plan even if the benefits are conditional on future employment (in other words, they are not vested). Employee service before the vesting date gives rise to an ~~constructive~~ obligation because, at each successive balance sheet date, the amount of future service that an employee will have to render before becoming entitled to the benefit is reduced. ...

Therefore the staff does not believe that option 1 would require further consequential amendments to the guidance on unvested benefits in IAS 19.

21. Regarding informal practices that leave the entity with little, if any, discretion to avoid paying employee benefits, the IAS 37 ED does not propose deleting ‘constructive’ from IAS 19. However, the staff would like to revisit that conclusion.
22. The *Framework* explicitly admits obligations arising from normal business practice, custom and a desire to maintain good business relations to act in an equitable manner. But the *Framework* does not label those obligations ‘constructive’. Therefore, the Board could overcome its previous concerns by deleting the word ‘constructive’ from these paragraphs of IAS 19 too, and instead relying on the *Framework*. For example, the proposed consequential amendment to paragraph 3 could be amended to read something along the lines of:
- 3 The employee benefits to which this Standard applies include those provided:
- ...
- (c) by those informal practices that may give rise to an ~~constructive~~ obligation. Informal practices may give rise to an ~~constructive~~ obligation when the entity has little, if any, discretion to avoid paying the employee benefits and the employees can reasonably rely on the entity to pay those benefits. An example of an ~~constructive~~ obligation arising from an entity’s informal practices is when a change in those the entity’s informal practices would cause unacceptable damage to its relationship with employees.⁷
23. Some may perceive this suggestion as setting an unintended precedent for phase 2 of the Employee Benefits project. But the staff thinks that we could manage this concern by using the Basis for Conclusions to explain that:
- any further consequential amendments to IAS 19 arising from the IAS 37 project are not intended to change current practice for employee benefits;
 - the Board will revisit the accounting for unvested benefits and informal employee benefits in phase 2 of the Employee Benefits project; and

⁷ Other paragraphs in IAS 19 requiring further amendment include 17, 19 and 52. We will also need to review the IAS 19 Basis for Conclusions.

- the different approaches in IAS 19 and IAS 37 are an inevitable consequence of one project moving forward ahead of another.

Nonetheless, the Board could face some awkward questions if, in the future, it decides to limit recognition of constructive obligations to those that a court could enforce in IAS 37, but continue to recognising employee benefits that arise from normal business practice in IAS 19.

Other points to consider

Interaction with the other proposals in the ED

24. The recognition principle underpinning the IAS 37 ED is that an entity shall recognise *all* items that satisfy the *Framework's* definition of a liability, subject to reliable measurement. Following option 1, an entity would not recognise some items that satisfy the definition of a liability, thus creating an exception to the recognition principle underpinning the ED.
25. Secondly, the ED proposes establishing IAS 37 as a general standard that captures all liabilities not within the scope of another standard. The Board decided to extend the scope of IAS 37 to ensure that no item that satisfies the *Framework's* definition of a liability falls through a “gap” between standards.⁸ Option 1 could create some tension with this proposal.

Potential re-exposure

26. In May 2007, some Board members expressed concern that option 1 would require re-exposure of the IAS 37 ED. [The staff has assessed] option 1 against the criteria for re-exposure in the *IASB Due Process Handbook*. Based on this [assessment], the staff thinks that the need for re-exposure as a result of following option 1 is not clear.

⁸ The Board noted the problems caused by this “gap” when it affirmed the proposed scope of the ED in March 2006. See agenda paper 5A.

27. Moreover, in their comment letters, several of those who questioned the Board’s decision not to follow option 1 in the ED also stated that they would not support such a move in IAS 37. Although most did not explain why.⁹ Therefore, as a minimum, the staff thinks that following option 1 is likely to increase demands for re-exposure.

C. EXPLAIN THE MEANING OF ‘BY EQUIVALENT MEANS’ (OPTION 2)

28. Option 2 is to recognise constructive obligations that a court could enforce *and* constructive obligations that are enforceable ‘by equivalent means’ and then explain the meaning of ‘by equivalent means’.

29. Option 2 seeks to achieve greater consistency in the accounting for constructive obligations by explaining when an entity may recognise as liabilities obligations that a court would not enforce. In the same way, Option 2 seeks to reconcile the accounting for constructive obligations with the Board’s tentative conclusions on distinguishing a liability from a business risk because it explains when an external party has a right to call upon an entity to act in a particular way.

A mechanism

30. The staff thinks that the reason why constructive obligations that a court could enforce are not “problems” in the context of this paper is because the law sets out the rules an entity must follow. The legal system then provides mechanism for monitoring compliance with those rules and imposing financial penalties for non-compliance.¹⁰ This is consistent with the Board’s tentative conclusions on how to distinguish a liability from a business risk - the legal system is a mechanism that establishes an external party’s right to call upon the entity to act in a particular

⁹ One respondent explained that they would oppose Option 1 because “it would consider only the legal form of these obligations and not their economic substance, and thus make financial statements less representationally faithful.”

¹⁰ At times there may be uncertainty about how the law applies to known facts and circumstances, or whether an entity’s actions have or have not applied with the law. This is uncertainty about the existence of a present obligation. Paper 10B covers this topic.

way thereby leaving an entity with little, if any, discretion to avoid settling an obligation.

31. Therefore, to explain the meaning of ‘by equivalent means’ the staff thinks that we need identify mechanisms outside of the legal system that establish an external party’s right to call upon an entity to act in a particular way. Ideally, those mechanisms should demonstrate the similar attributes to a legal system. Namely, rules, a system to monitor performance against those rules and an ability to impose financial penalties for non-compliance.
32. The staff has identified four general examples to demonstrate that such mechanisms do exist outside of the legal system. This is not intended to be an exhaustive list.
 - (a) *Mechanisms established by government operating in parallel with the court system.* For example, in the UK, parliament established the Financial Ombudsman Service (an independent organisation) to help settle disputes between financial services organisations and their customers. Customers are not obliged to accept an ombudsman's decision, but if they do the ombudsman’s decision is binding both for parties.¹¹
 - (b) *Industry regulators.* Entities operating in particular industries often follow industry-specific regulations. Either independent bodies operating in parallel with the court system (regulators) or entities themselves (self-regulators) monitor compliance with these regulations and have the ability to impose financial penalties for non-compliance. For example, the Water Services Regulation Authority (Ofwat) regulates entities operating in the water and sewerage industry in England and Wales.¹²
 - (c) *Trade and professional associations.* Many entities and/or their staff are members of trade or professional associations. Most associations have

¹¹ Source: <http://www.financial-ombudsman.org.uk>

¹² Source: <http://www.ofwat.gov.uk/>

agreed-upon regulations or codes of conduct, with internal monitoring and disciplinary procedures. Some associations have delegated authority from government or another legal body to impose penalties for non-compliance. For example, in the UK, the General Medical Council has delegated authority to oversee the professional practice of doctors.¹³ Other associations' authority to impose penalties for non-compliance comes from widespread industry support. For example, the British Codes of Advertising Practice applied by the Advertising Standards Authority.¹⁴

- (d) *Internal, entity-specific initiatives.* An example of an internal, entity-specific initiative is a Customer Service Charter. According to the website of one Australian entity, their Customer Service Charter is a voluntary initiative that specifies measurable customer service commitments (for example, a detailed response to all written enquiries within five working days). If the entity fails to honour a commitment it must pay a fixed financial penalty to the customer. The entity monitors performance against its Charter internally and through an independent audit.¹⁵

Arguments in favour

33. The staff has identified the following arguments in favour of option 2 compared to option 1:
- (a) no exception from the recognition principle and scope proposed in the IAS 37 ED.
 - (b) consistency with the Board's more recent redeliberations on stand ready obligations. Here the Board concluded that the form of the mechanism (contractual or non-contractual) should not change the conclusion that an

¹³ Source: <http://www.gmc-uk.org/index.asp>

¹⁴ Source: <http://www.asa.org.uk/asa/>

¹⁵ Source: www.aami.com

obligation exists.¹⁶ In the same way, the form of the mechanism (legal or extra-legal) should not change the conclusion that an obligation exists.

(c) less controversial because option 2 is less likely to change current practice and is more obviously consistent with paragraph 60 of the *Framework*.

34. The staff also thinks that concerns about the potential effect of following option 2 on the accounting for items described as ‘constructive obligations’ in IAS 19 could be overcome using the approach described in paragraphs 20-24.

Arguments against

35. On the other hand, the staff thinks that option 2 highlights the problems caused by *not* fundamentally reconsidering the notion of a constructive obligation as part of this project. As a result, the staff questions whether option 2 will achieve greater consistency in the accounting for constructive obligations.

36. For example, some of the mechanisms identified above have some legal foundation – delegated authority from a legal body, for example. For some, the IAS 37 definition of a legal obligation already captures these mechanisms. However, others are less comfortable with this conclusion.

37. Some of the mechanisms identified above have no legal foundation. But, is industry pressure, by itself, sufficient to oblige an entity to join a professional association and to pay any financial penalties imposed for non-compliance with an association’s regulations or code of conduct? Option 2 does not answer this question and therefore, compared to Option 1, is unlikely to achieve consistency in practice. For example, in response to this question:

- some would answer “yes”: the *Framework* admits that some obligations stem from normal business practice, custom and a desire to maintain good business relations. Therefore, in some situations, industry pressure or a

¹⁶ See agenda paper 3C discussed in March 2007

desire to avoid dispute can leave an entity with little, if any discretion, to avoid settling an obligation.

- others would answer “no”: any discretion, no matter how little, means that an entity is not obliged to act in a particular way. Industry pressure is an example of economic compulsion.

D. RETAIN THE PROPOSALS IN THE ED (OPTION 3)

38. Option 3 is the same as option 2, but proposes using the explanatory text already in paragraph 15 of the ED as a proxy for explaining ‘by equivalent means’. In other words, Option 3 seeks to achieve greater consistency in the accounting for constructive obligations by emphasising that a constructive obligation involves an obligation to others.

39. The words in paragraph 15 of the ED could be reconciled with the Board’s tentative conclusions on distinguishing a liability from a business risk by amending the proposed text to read something along the lines of:

15 In the absence of legal enforceability, particular care is required in determining whether an external party has a right to call upon an entity to act in a particular way. ~~entity has a present obligation that it has little, if any, discretion to avoid settling.~~ In the case of a constructive obligation, this will only be the case if:

- (a) the entity has indicated to other parties that it will accept particular responsibilities;
- (b) the other parties can reasonably expect the entity to perform those responsibilities; and
- (c) the other parties will either benefit from the entity’s performance or suffer harm from its non-performance.

Arguments in favour

40. Compared to Option 2, Option 3 is more structured and less ambiguous. As a result, the staff thinks Option 3 is more likely to achieve greater consistency in the accounting for constructive obligations.

41. Admittedly, Option 3 is more ambiguous than Option 1. But, Option 3 comes with the following advantages:
- (a) no exception to the recognition principle and scope proposed in the IAS 37 ED.
 - (b) retains the explanatory text that a majority of respondents supported in their comment letters.

Arguments against

42. However, the some may question whether option 3 truly reconciles an external party's 'right' to call upon an entity to act in a particular way with an external party's 'valid expectation' that it can 'reasonably rely on' the entity to act in a particular way. For example, past practice may create a 'valid expectation' amongst employees that an entity will pay a year end bonus. A trade union is a formal mechanism that an employee can use to exert pressure (by threatening to strike, for example) on management to pay that bonus. But does the ability to exert pressure establish an employee's *right* to call upon an entity to pay a bonus?
43. Moreover, for some 'right' is much stronger than 'valid expectation' that others can 'reasonably rely on', and implies 'legal right'. The staff deliberately stopped short of 'legal right' when drafting the Board's tentative conclusions on distinguishing a business risk from a liability. However, *The Compact Oxford English Dictionary* lists many definitions of 'right', including 'a moral or *legal* entitlement to have or do something' (emphasis added). Applying this definition, option 3 is no different to option 1.

E. COMPARATIVE ANALYSIS

44. The staff does not find any of the options analysed above wholly satisfactory. But, on balance, the staff recommends Option 3. The staff reached this conclusion by a process of elimination. The staff first dismissed Option 2 because this option is unlikely to achieve greater consistency in the accounting for

constructive obligations. Next, the staff dismissed Option 1 because the staff thinks that Option 1 over-steps the boundaries of this project and may require re-exposure.

45. The staff acknowledges the concerns associated with using the word ‘right’ to distinguish a liability from a business risk. Therefore, the staff also proposes replacing the word ‘right’ with ‘ability’ – a word that conveys the same intention as ‘right’ without the legal connotations.¹⁷
46. Following the staff’s recommendation, the Board’s tentative conclusions on distinguishing a liability from a business risk would be amended and coupled with the proposed text on constructive obligations to read something along the lines of:

A present obligation exists when an entity is ~~irrevocably committed~~ presently bound to act in a particular way. As a result, an external party ~~can~~ ~~has an enforceable right to~~ call upon the entity to act in a particular way. Consequently, an ~~irrevocable~~ action or event, by itself, does not give rise to a present obligation. A mechanism that ~~provides~~ ~~establishes~~ an external party’s with the ability right to call upon the entity to act in a particular way is also required.

In the absence of legal enforceability, particular care is required in determining whether an external party can call upon an entity to act in a particular way. ~~has a present obligation that it has little, if any, discretion to avoid settling.~~ In the case of a constructive obligation, this will only be the case if:

- (a) the entity has indicated to other parties that it will accept particular responsibilities;
- (b) the other parties can reasonably expect the entity to perform those responsibilities; and
- (c) the other parties will either benefit from the entity’s performance or suffer harm from its non-performance.

Does the Board agree?

¹⁷ *The Compact Oxford English Dictionary* defines ability as ‘the power or capacity to do something’.

F. IS THERE ANYTHING ELSE WE COULD DO?

47. As noted in Section A, separately defining legal and constructive obligations in IAS 37 sometimes causes confusion. This confusion may, at times, obscure the more fundamental question “what makes a constructive obligation an *obligation* in the absence of legal enforceability?”
48. Regardless of the Board’s decision on options 1, 2 and 3 above, one further step this paper asks the Board to consider is incorporating the existing definitions of legal and constructive obligations into the text of the ED, rather than including them as defined terms. At this point the staff would like to emphasise that the suggestion is to move, not remove, the definitions of legal and constructive obligations. For example, paragraphs 14 and 15 of the ED could incorporate the current definitions of legal and constructive obligation in the following way:

Definition in the ED	Explanatory text in the ED	Incorporated definitions into text
<p>A legal obligation is a present obligation that arises from the following:</p> <p>(a) a contract (through its explicit or implicit terms)</p> <p>(b) legislation; or</p> <p>(c) other operation of law.</p>	<p>Because most liabilities arise from legal obligations, settlement can be enforced by a court. Some liabilities arise from constructive obligations, in which the obligation is created by, or inferred from, an entity's past actions rather than arising from an explicit agreement with another party or from legislation. In some jurisdictions, constructive obligations may also be enforced by a court, for example, in accordance with the legal principle known in the United States as promissory estoppel or principles having the same effect under other legal systems.</p>	<p>Because most <u>present obligations</u> liabilities arise from contract law, statute or other operation of law, the legal system provides an external party with the ability to call upon an entity to act in a particular way. Legal obligations, settlement can be enforced by a court. In many jurisdictions <u>the legal system also captures</u> Some liabilities arise from constructive obligations, in which the obligation is created by, or inferred from, an entity's past actions <u>as well as obligations</u> rather than arising from <u>direct application of a law or statute, an explicit agreement with another party or from legislation.</u> In some jurisdictions, constructive obligations may also be enforced by a court, for example, in accordance with the legal principle known in the United States as promissory estoppel or principles having the same effect under other legal systems.</p>
<p>A constructive obligation is a present obligation that arises from an entity's past actions when:</p> <p>(a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept particular responsibilities; and</p> <p>(b) as a result, the entity has created a valid expectation in those parties that they can reasonably rely on it to discharge those responsibilities.</p>	<p>In the absence of legal enforceability, particular care is required in determining whether an entity has a present obligation that it has little, if any, discretion to avoid settling. In the case of a constructive obligation, this will only be the case if:</p> <p>(a) the entity has indicated to other parties that it will accept particular responsibilities;</p> <p>(b) the other parties can reasonably expect the entity to perform those responsibilities; and</p> <p>(c) the other parties will either benefit from the entity's performance or suffer harm from its non-performance.</p>	<p>In the absence of legal enforceability, particular care is required in determining whether an <u>external party can call upon an entity to act in a particular way.</u> entity has a present obligation that it has little, if any, discretion to avoid settling. In the case of a constructive obligation, this will only be the case if:</p> <p>(a) <u>by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to</u> other parties that it will accept particular responsibilities;</p> <p>(b) <u>as a result the entity has created a valid expectation in</u> the other parties <u>that they</u> can reasonably rely on <u>expect</u> the entity to perform those responsibilities; and</p> <p>(c) the other parties will either benefit from the entity's performance or suffer harm from its non-performance.</p>

Arguments in favour

49. The staff thinks that this option would help to reduce confusion by further softening the dividing line between legal and constructive obligations. This is option is also consistent with the approach already taken by the Board in the ED and does not obviously conflict with the *Framework*.
50. Specifically in relation to the definition of a legal obligation:
- (a) paragraph 60 in the *Framework* explicitly states that obligations may be legally enforceable as a consequence of a binding contract or statutory requirement. Repeating at a standards-level is unnecessary duplication.
 - (b) the IAS 37 definition of a legal obligation adds little value to the words in the *Framework*. The *Framework* only refers to contracts and statute. However, there seems to be little opposition to the observation that ‘legally enforceable’ (the words in the *Framework*) captures other items such as those identified in paragraph 11(b).
 - (c) the IAS 37 ED amends the existing definition of a legal obligation to read: “a legal obligation is a present obligation that arises from the following ...” This conflicts with the Board’s analysis of contractual obligations (examples of legal obligations) into unconditional and conditional obligations, with only unconditional obligations being present obligations.
51. Specifically in relation to the definition of a constructive obligation:
- (a) in their comment letters, several constituents commented that the additional text in the proposed paragraph 15 of the ED is more helpful than the proposed amendment to the definition of a constructive obligation.
 - (b) removing the definition of a constructive obligation would increase consistency with US GAAP. US GAAP describes constructive

obligations but does not seek to define them in the same way as IAS 37.

Arguments against

52. However, arguments against this proposal include:
- (a) ‘constructive obligation’ is a commonly used term. However, the current IASB *Framework* does not define constructive obligations, unlike the frameworks of most other standard setters. Therefore, the Board should not remove the definition of a constructive obligation from IAS 37 without amending the *Framework*. This is a task for the Conceptual Framework project.
 - (b) incorporating the definitions of legal and constructive obligations into the text of IAS 37 could be perceived as a bigger change than intended – ie removing rather than moving legal and constructive obligations.
 - (c) this is a cosmetic change that does not address the real issue associated with constructive obligations. Why risk the potential mis-perceptions identified in (b)?

Staff comment

53. Again, the staff thinks that there is no obvious “yes” or “no” answer. On balance, the staff favours incorporating the definitions of legal and constructive obligations into the text of the ED. In making this recommendation, the staff emphasises that it is not looking to change any aspect of the current definitions, only move their location in any final standard.

Does the Board agree?

[Appendix is omitted from the observer notes]