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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 March 2007, London

Project: Liabilities - amendments to IAS 37

Subject: IAS 37 Redeliberations: Stand ready obligations
(Agenda Paper 3C)

INTRODUCTION

1. The IAS 37 ED introduces the notion of a 'stand ready obligation'. The objective of this paper is to identify when and why a stand ready obligation exists by building on the examples and analysis in agenda paper 3B. This paper divides into the following sections:

Section 1: What is a stand ready obligation?

Section 2: Can we apply the notion of a stand ready obligation to non-contractual scenarios?

Section 3: Do we need the term 'stand ready obligation'?

SECTION 1: WHAT IS A STAND READY OBLIGATION?

The IAS 37 ED

2. Paragraph 22 in the IAS 37 ED explains that ‘in some cases, an entity has a liability even though the amount that will be required to settle that liability is contingent (or conditional) on the occurrence or non-occurrence of one or more uncertain future events. In such cases, an entity has incurred two obligations as a result of an event – an unconditional and a conditional obligation’. The ED uses the term ‘stand ready obligation’ to describe this type of liability.¹
3. The Basis for Conclusions accompanying the ED explains that an unconditional obligation exists when ‘nothing other than the passage of time is required to make its performance due’. A conditional obligation exists when ‘performance is subject to the occurrence of an event that is not certain to occur’. A liability may arise as a result of an unconditional obligation, but not a conditional obligation.²
4. The Conceptual Framework project also describes a third type of obligation: a ‘mature’ obligation. A mature obligation exists when ‘performance is not subject to any event, including the passage of time’. (For example, an obligation for accounts payable once the due date for the payable has been reached.) A liability may arise as a result of a mature obligation.

Re-capping previous discussions

5. In their comment letters many constituents were concerned that the ED’s explanation of a ‘stand ready obligation’ is too broad and seems to capture business risks as well as liabilities. Responding to these concerns, in May 2006 the Board confirmed that a stand ready obligation must satisfy the definition of a liability. In other words, a stand ready obligation is not a business risk.

¹ IAS 37 ED, paragraphs 22 and 24.

² IAS 37 ED, paragraph BC11.

6. Consequently, the remainder of this section builds on the examples in agenda paper 3B that satisfy the definition of liability. Logically, the examples that do not satisfy the definition of a liability in agenda paper 3B (Examples 1A, 1B, 1E, 2D, 3A, 3B, 3D and 3E) cannot be stand ready obligations. Also, this paper does not build on Example 3B because the staff has not yet reached a consensus view on this example, for the reasons given in agenda paper 3B.

Further analysis

7. The staff has reviewed the examples in section 3 that satisfy the definition of a liability in the light of the explanations of unconditional, conditional and mature obligations.³ The staff’s conclusions are summarised in the table below.

Example summary	Type of obligation	Additional comment
1C – in Jurisdiction A environmental rehabilitation laws state that all mine shafts deeper than 10 metres must be entirely filled in by 31 December 2020. On the balance sheet date Digger has mined five shafts in Jurisdiction A and each shaft is 12 metres deep.	Unconditional	Nothing more than the passage of time is required before Digger must entirely fill-in all mine shafts that are deeper than 10 metres in Jurisdiction A.
1D – facts as Example 1C, except that the law in Jurisdiction A states that all mine shafts deeper than 10 metres must be entirely filled in “when mining operations cease”. (In this example the staff has assumed that Digger’s ability to mine is finite).	Unconditional	There is some uncertainty about <i>when</i> Digger will cease mining and therefore, <i>when</i> Digger must entirely fill-in all mine shafts that are deeper than 10 metres. But there is no doubt that Digger must entirely fill-in all mine shafts that are greater than 10 metres. Therefore Digger’s obligation is unconditional: nothing more than the passage of time is required before performance is due.

³ The staff thinks that its analysis of the examples in agenda paper 3B is consistent with the description of unconditional, conditional and mature obligations and its conclusions in this paper. For example, in Example 1B the staff concludes that Digger does not have a liability in Jurisdiction A because he has not yet mined deeper than 10 metres (the depth specified in the environmental rehabilitation law). Using the descriptions in this paper, Digger has a conditional obligation to fill-in shafts deeper than 10 metres. Digger’s obligation is conditional because performance is subject to something other than the passage of time – ie Digger mines deeper than 10 metres, an event which Digger can avoid at the balance sheet date.

Example summary	Type of obligation	Additional comment
<p>1F – in Jurisdiction B there are no environmental rehabilitations laws. But Digger has offered to apply the same standards as in Jurisdiction A if the municipal council extends Digger’s right to mine for another 15 years. On the balance sheet date the municipal council has accepted Digger’s offer. Digger has mined five shafts in Jurisdiction B and each shaft is 12 metres deep.</p>	<p>Unconditional</p>	<p>Nothing more than the passage of time is required before Digger must entirely fill-in all mine shafts that are deeper than 10 metres in Jurisdiction B.</p>
<p>2A – Auto has made an irrevocable offer to enter into a break down services agreement if a driver returns a signed agreement on or before 31 January 2011. On 31 December 2010 no drivers have returned a signed agreement.</p>	<p>Unconditional & conditional</p>	<p>Auto’s promise to enter into a services agreement is unconditional because his offer is irrevocable. But Auto’s promise to provide service coverage is conditional upon a driver returning a signed services agreement – an event that is not certain to occur.</p>
<p>2B – facts as Example 2A, except that one driver has returned a signed services agreement. The agreement is for 12 months and is non-cancellable. On 31 December 2010 Driver’s car has not broken down.</p> <p>2C – facts as Example 2B, except that both Auto and Driver can cancel the agreement with 1 month’s notice.</p>	<p>Unconditional & conditional</p>	<p>Auto’s promise to protect Driver from the risk that his car will break down is unconditional because his promise is irrevocable for the non-cancellable period of the services agreement.</p> <p>Auto’s promise to repair Driver’s car is conditional upon the car breaking down during the period of the services agreement – an event that is not certain to occur.</p>

Example summary	Type of obligation	Additional comment
2D – facts as Example 2B, except that on 31 December 2010 Driver notifies Auto that his car requires repair.	Mature	Auto must repair Driver’s car because the car has already broken down within the period of the services agreement. (The unconditional promise to provide service coverage continues until the end of the 12-month period.)
3C – Vendor sells hamburgers in a jurisdiction with no minimum food hygiene standards. But the law of that jurisdiction stipulates that if a customer is hospitalised as a result of eating a contaminated hamburger, the supplier of that hamburger must pay compensation of £100,000 to the customer. Vendor has sold a contaminated hamburger and Customer is in hospital as a result of eating that hamburger.	Mature	Vendor must pay compensation because Customer is already in hospital as a result of eating a contaminated hamburger sold by Vendor.

8. Reviewing the analysis in agenda paper 3B in the light of the ED's description of a stand ready obligation, only examples 2A, 2B and 2C could be described as stand ready obligations. This is because they are the only examples where a conditional obligation accompanies an unconditional obligation.
9. So, what distinguishes a stand ready obligation? In all of these examples, Auto's unconditional promise exists separately from his conditional promise. However, the likelihood of the uncertain event occurring impacts the *value* of Auto's unconditional promise. For example, in Example 2B Auto's conditional promise to repair Driver's car exists separately from Auto's unconditional promise to protect Driver against the risk that his car will break down. But the likelihood that Driver's car will break down and the likely nature of that repair impacts the *value* of Auto's unconditional promise.
10. As a result, the staff thinks that the notion of a 'stand ready obligation' describes those unconditional obligations whereby an external party has a present enforceable right to call upon an entity to act in a certain way in the future, but may not do so. *Measurement* of the unconditional obligation depends on the likelihood that the external party will exercise its right to call upon the entity to act in the future (thereby turning the associated conditional obligation into an unconditional obligation).
11. The staff thinks that this conclusion is consistent with the use of 'stand ready obligation' in other accounting literature. For reference, appendix A provides extracts from other accounting literature illustrating the use of the notion of a 'stand ready obligation'.

Does the Board agree that the notion of a stand ready obligation describes those unconditional obligations whereby an external party has a present enforceable right to call upon an entity to act in a certain way in the future, but may not do so?

SECTION 2: CAN WE APPLY THE NOTION OF A STAND READY OBLIGATION TO NON-CONTRACTUAL SCENARIOS?

The IAS 37 ED

12. The Basis for Conclusions explains that the Board's 'analysis of the relationship between conditional and unconditional contractual rights [and obligations] could be applied more widely'. The ED therefore applies the notion of a stand ready obligation to both contractual and non-contractual scenarios.⁴

Re-capping previous discussions

13. In their comment letters most constituents were comfortable applying the notion of a stand ready obligation to contracts. But they were uncomfortable extending the notion to non-contractual scenarios. For example, several constituents asked whether an entity stands ready to comply with a statute or a regulation in the same way that it stands ready to honour the terms and conditions of a contract. If not, what is the difference between an unconditional obligation to comply with existing laws and regulations and an unconditional obligation to comply with the terms and conditions of a contract?
14. In May 2006 the staff argued that the notion of a stand ready obligation can be extended to non-contractual scenarios. In particular the staff noted that SFAS 143 *Accounting for Asset Retirement Obligations* provides an example of when a stand ready obligation may be imposed by law.⁵ (Appendix A includes an outline of this example.)
15. Moreover, almost all constituents opposed the Board's argument that the start of legal proceedings gives rise to a liability because an entity 'stands ready to act as the court directs'. In June 2006 the Board tentatively agreed that the conclusion in the ED is incorrect and that, in itself, the start of legal proceedings does not satisfy the definition of a liability.

⁴ IAS 37, paragraph BC 14 and paragraphs 22-26.

⁵ See agenda paper 10D, appendix A, paragraphs A8-A13.

Further analysis

16. The staff agrees that contracts are the clearest and most prevalent examples of stand ready obligations. However, the staff continues to think that the notion of a stand ready obligation can be extended to non-contractual scenarios. The staff has identified four different scenarios when the notion of a stand ready obligation might apply: offers enforceable at law, written options, contractual promises to perform and statute/regulations.

Offers enforceable at law

17. An entity might make an offer to act in a certain way in the future, but that offer has not yet been accepted and no consideration has changed hands. As a result, the offer is not yet captured by contract law. However, in some jurisdictions another law may state that an offer is irrevocable. For example, the Uniform Commercial Code in the United States states that “firm offers” are irrevocable if the offeror gives written assurance that an offer will be held open. In such circumstances, although there is no contract, the offeror *stands ready* to honour the offer.
18. In some jurisdictions, Example 2A is an example of an offer enforceable at law. In this example, Auto’s offer to enter into a services agreement with fifty drivers is irrevocable and, hence, gives rise to a present (unconditional) obligation. Auto may not be called upon to enter into any services agreement, or Auto may be called upon to enter into fifty services agreements. But Auto *stands ready* to honour his offer, regardless of how many drivers accept his offer by returning a signed services agreement.
19. At this stage the staff thinks that it is important to emphasise that revocable (or non-binding) offers are not stand ready obligations. Equally not revoking an offer on or before the balance sheet date does not give rise to a stand ready obligation.⁶ This is because revocable offers do not give rise to a present obligation; hence no liability exists (see Example 1E in agenda paper 3B).

⁶ Assuming the external party has not already accepted and the entity is unaware of that acceptance on the balance sheet date.

Written options

20. An entity might more formally document its offer to act in a certain way in the future in a contract with an external party. In the contract, the entity grants an external party the right to call upon the entity to act in a certain way in the future (potentially in exchange for consideration). The external party accepts. Such an agreement also gives rise to a present (unconditional) obligation. In such circumstances, although the external party may choose not to exercise their option, the entity *stands ready* to abide by that option.
21. In some jurisdictions, Example 2A may be an example of written option. In this example, Auto has written an option to fifty drivers giving them the right to enter into a services agreement. No drivers may exercise their right to enter into a services agreement, or fifty drivers may exercise their right. But Auto *stands ready* to abide by that option, regardless of how many drivers exercise their option by returning a signed services agreement
22. The staff thinks that it is important to emphasise that an option holder does not have a stand ready obligation. This is because the ability to choose whether or not to exercise an option does not satisfy the definition of a liability (see Example 1B in agenda paper 3B).

Contractual promises to perform

23. An entity may offer to protect an external party from the risk that an uncertain future event will occur (potentially in exchange for consideration). The external party accepts. Such an agreement also gives rise to a present (unconditional) obligation. But this type of agreement is different to a written option because neither the entity nor the external party can influence whether or not the uncertain event occurs. Nonetheless, the entity *stands ready* to accept the consequences of that event occurring.
24. Example 2B is an example of a contractual promise to perform. In this example, Auto's irrevocable promise to protect Driver against the risk that his car will require repair during the contract period gives rise to a present (unconditional) obligation. Auto may not be called upon to repair Driver's car, or Auto may be called upon to repair Driver's car several times during the

contract period. But Auto *stands ready* to honour his promise, regardless of how many times Driver's car requires repair.

25. The staff thinks that it is important to emphasise that contractual promises do not give rise to stand ready obligations beyond the non-cancellable period of the contract (see Example 2C in agenda paper 3B).

Statute/regulations

26. SFAS 143 *Accounting for Asset Retirement Obligations* provides an example of a statutory stand ready obligation (see appendix A for the fact pattern). In this example, the entity's irrevocable past action means that the entity is legally required to perform asset retirement activities. The government may call upon the entity to perform asset retirement activities, or the government may choose to waive the entity's legal requirement to perform asset retirement activities. But the entity *stands ready* to perform, regardless of the government's ultimate decision.
27. At this stage the staff thinks that it is important to emphasise that operating in a jurisdiction subject to a particular law, statute or regulation does not give rise to a stand ready obligation to comply. An action or event is also required (see Examples 1A, 1B and 3A in agenda paper 3B).
28. The staff thinks that it is appropriate to use the notion of a stand ready obligation in all four scenarios. This is because in all four scenarios an unconditional obligation exists whereby an external party has a present enforceable right to call upon an entity to act in a certain way in the future, but may not do so.
29. Moreover, in agenda paper 3B the staff argued that laws (including contract law) and regulations by themselves are not present obligations. They are simply examples of mechanisms that establish an external party's right to call upon the entity to complete a particular action. For example, in agenda paper 3B the only difference between Example 1C and Example 1F is that the mechanism underpinning Digger's obligation in 1C is a statute, whereas the mechanism underpinning Digger's obligation in 1F is a contract. Consequently, the staff does not think it is necessary or appropriate to

distinguish contractual obligations from other legal obligations by applying the notion of a stand ready obligation to contracts only.

Does the Board agree that the notion of a stand ready obligation can be applied to non-contractual scenarios?

SECTION 3: DO WE NEED THE TERM ‘STAND READY OBLIGATION’?

The IAS 37 ED

30. In the Basis for Conclusions, the Board acknowledges that its analysis of unconditional and conditional rights and obligations may appear complex and that some constituents already identify stand ready obligations as liabilities. However, the Board also noted that the objective of its analysis is ‘to assist in identifying precisely the liability in existence at the balance sheet date, rather than relying on an assessment of some uncertain future event to determine whether a liability exists at that date.’⁷

Re-capping previous discussions

31. In their comment letters and at the IAS 37 round-tables some constituents agreed that the term ‘stand ready obligation’ is useful in explaining why items such as unexpired insurance policies, written options and extended product warranties satisfy the definition of a liability. One Norwalk round-table participant (who is also a member of the insurance working group) urged others to continuing using the term, even though it may seem odd at first.
32. However, other constituents argued that the term ‘stand ready obligation’ is unnecessary. One Melbourne round-table participant suggested that the Board drop the notion of a stand ready obligation, and simply focus on clearly explaining when and why a liability exists.
33. Other constituents argued that the Board’s analysis of unconditional and conditional obligations and stand ready obligations is confusing and unhelpful. Some thought that the term ‘stand ready obligation’ in the ED simply replaced the term ‘contingent liability’.

⁷ IAS 37 ED, paragraph BC26.

Further analysis

34. The staff agrees that explaining when and why a liability exists is more important than the term we attach to that explanation. The staff also agrees that the *notion* of a stand ready obligation identifies more precisely the liability in existence at the balance sheet date (for the reasons outlined by the Board in the Basis for Conclusions to the IAS 37 ED).
35. Some staff members therefore think that we should retain the *term* ‘stand ready obligation’ in the IAS 37 ED. In particular, these staff note that:
- clarifying the distinction between a liability and a business risk (agenda paper 3B) and improving the ED’s explanation of a stand ready obligation (section 1 of this paper) may alleviate some of the concerns and confusion expressed in the comment letters and at the round-tables.
 - the term ‘stand ready obligation’ is used regularly in US GAAP literature. Using different words to explain the same notion in IFRS literature could increase, rather than resolve, confusion.
 - time is required to establish a comfort-level with any new term. As noted by one round-table participant, some members of the insurance working group have become increasingly comfortable with the term ‘stand ready obligation’ over time.
 - the term is useful short-hand for the detailed analysis in this paper and in agenda paper 3B.
36. However, some staff members favour dropping the *term* ‘stand obligation’ when revising the text of the IAS 37 ED. In particular, these staff:
- agree with those round-table participants who argued that explaining when and why a liability exists is more important than the term we attach to that explanation.
 - note that the recognition principle in the ED is to recognise all items that satisfy the definition of a liability. In agenda paper 3B we were

able to analyse when and why a liability exists *without* using the term ‘stand ready obligation’.

- are concerned that distinguishing features of a stand ready obligation (compared to all other present obligations) are too subtle to be useful and may not translate easily.
- note that dropping the term when revising the text of the IAS 37 ED will not prevent the Board using the term in other projects where its application is less contentious.

37. These staff members acknowledge that whether or not we drop the *term* ‘stand ready obligation’ does not eliminate the need to clarify the important notion that the IAS 37 ED tries to convey.

Does the Board wish to continue using the phrase ‘stand ready obligation’ when revising the IAS 37 ED?

APPENDIX A: Use of ‘stand ready obligation’ in accounting literature

A1. The notion of a ‘stand ready obligation’ derives from US GAAP. The staff thinks that its conclusion in section 1 of this paper is consistent with the use of ‘stand ready obligation’ in US GAAP. Examples include:

- Concepts Statement No. 6 *Elements of Financial Statements* uses the term ‘stand ready’ to explain that a liability ‘may not require an entity to pay cash, but to convey other assets, to provide *or stand ready to provide* services, or to use assets’.⁸
- FIN 45 *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* explains that a guarantor has an obligation ‘*to stand ready to perform over the term of the guarantee in the event that the specified triggering events or conditions occur (the noncontingent aspect)*’.⁹ FIN 45 also clarifies that because a guarantee imposes a noncontingent obligation to stand ready to perform, SFAS 5 *Accounting for Contingencies* should not be used to prohibit the guarantor recognising a liability even when it is not probable that payments will be required under the guarantee.¹⁰
- SFAS 143 *Accounting for Asset Retirement Obligations* explains that government may retain the right (an option) to decide whether a retirement activity will be required or waived. A liability to stand ready to perform the retirement activity exists, despite uncertainty about whether or not performance will be required. Rather, ‘that uncertainty is factored into the measurement of the fair value of the liability’.¹¹

⁸ CON 6, paragraph 36 (emphasis added)

⁹ FIN 45, paragraph 8 (emphasis added)

¹⁰ FIN 45, paragraph 9, A36 and A37

¹¹ SFAS 143, paragraph A17. See also FIN 47 *Accounting for Conditional Asset Retirement Obligations*, paragraphs 5(a) and B21.