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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting:	**17 May 2007, London**
Project:	**Liabilities (amendments to IAS 37) & Conceptual Framework (elements and recognition)**
Subject:	**Uncertainty about the existence of a present obligation ("Return of the Hamburger") (Agenda paper 7)**

INTRODUCTION

1. In March 2007, the Board discussed a series of examples to assist in distinguishing a liability from a business risk. As a result of working through those examples the Board identified a crucial tension point, which we described at that time as: distinguishing uncertainty about the existence of a present obligation from a stand ready obligation. The Board discussed the example illustrating this tension point (example 3B in agenda paper 3B) but did not reach a consensus. This paper continues that discussion.

2. The paper divides into the following sections:

   A. Fact pattern

B. Uncertainty about the existence of a present obligation rather than a stand ready obligation

C. Alternative approaches to addressing uncertainty about the existence of a present obligation

D. Comparative analysis of alternatives

E. Next steps

F. Summary: what have we learned so far?

Two appendices accompany the paper. Appendix A reconciles the analysis in this paper back to the fact pattern previously discussed by the Board. Appendix B applies the alternative approaches to addressing uncertainty about the existence of a present obligation in section C to the fact pattern in section A.

3. As with the March 2007 discussion, this issue relates to both the IASB's IAS 37 project and the definition of a liability in the joint IASB/FASB Conceptual Framework project. Accordingly, staff from both the IAS 37 and Conceptual Framework project teams collaborated in preparing this paper.

A. FACT PATTERN

4. The staff has modified the fact pattern of the example previously discussed by the Board in order to focus this month's discussion on the views explored in this paper.[1]

[1] In Example 3B (in agenda paper 3B, March 2007) the law stipulated that a customer is entitled to £100,000 compensation if a hamburger is contaminated at the point of sale *and* the customer is hospitalised as a result of eating that hamburger. Also, Example 3B provided no information about Vendor's past experience. For reference, Appendix A reconciles the analysis in this paper back to the fact pattern previously discussed by the Board.

Vendor sells hamburgers in a jurisdiction where the law stipulates that the vendor must pay compensation of £100,000 to each customer that purchases a contaminated hamburger.

On 31 December 200X (the balance sheet date), Vendor has sold one hamburger to Customer.

Past experience indicates that one in a million hamburgers sold by Vendor is contaminated. No other information is available.

5. In this paper, the staff assumes Vendor only pays compensation when required to do so by law. The staff acknowledges that, in some situations, Vendor may have a constructive obligation to pay compensation before required to do so by law. However, constructive obligations are outside the scope of this paper. Any potential interaction between this example and the thinking being developed in the revenue recognition project is also outside the scope of this paper.

B. UNCERTAINTY ABOUT THE EXISTENCE OF A PRESENT OBLIGATION RATHER THAN A STAND READY OBLIGATION

6. The staff thinks that the fact pattern above illustrates uncertainty about the existence of a present obligation, rather than a stand ready obligation. Put simply, did Vendor sell a contaminated hamburger? That is to say, in March 2007 we inadvertently mis-labelled View B in that paper. To explain the staff's conclusion, this section contrasts this fact pattern with the fact patterns in two examples of stand ready obligations previously accepted by the Board: an extended product warranty and a written option.

Extended product warranty

On 1 December 200X Retailer sells an extended product warranty that requires him to repair Customer's product if it breaks down during the warranty period. The warranty is non-cancellable and expires on 31 May 200Y. The balance sheet date is 31 December 200X.

Written option

On 1 December 200X Farmer writes an option that requires him to deliver 1000 bushels of corn to Canner for $3 per bushel if Canner exercises the option before a specified date. The option is non-cancellable and expires on 31 May 200Y. The balance sheet date is 31 December 200X.

No future event

7. Previously the Board observed that a stand ready obligation results from an unconditional obligation associated with a conditional obligation. An unconditional obligation arises when 'nothing other than the passage of time is required to make its performance due'. A conditional obligation arises when 'performance is subject to the occurrence of a future event that is not certain to occur'. An unconditional obligation is a present obligation and therefore may give rise to a liability. A conditional obligation is not a present obligation and, therefore, cannot give rise to a liability.[2]

8. In the extended product warranty and written option examples, a stand ready obligation exists because an unconditional obligation associated with a conditional obligation exists on the balance sheet date.

	Unconditional obligation	**Conditional obligation**
Retailer	Provide warranty coverage until 31 May 200Y.	Repair Customer's product *if* it breaks down during the remainder of warranty period.
Farmer	Protect the price and availability of 1000 bushels of corn until 31 May 200Y.	Deliver 1000 bushels of corn for $3 per bushel *if* Canner exercises the option before 31 May 200Y.

9. In both of these examples, the staff thinks that there is potentially more than one unconditional obligation. For example, Retailer may have an *unconditional*

[2] IAS 37 ED, paragraph BC11 and affirmed in March 2007 (agenda paper 3C).

obligation (rather than *conditional*) to repair Customer's product as a result of a break down that is known to have occurred before the balance sheet date. Equally, Retailer may have an *unconditional* obligation (rather than *conditional*) to repair Customer's product as a result of a break down that occurred before the balance sheet date, but has not yet been reported. (Situations often described as 'incurred but not reported' (IBNR) in the insurance industry.) But these unconditional obligations could not be described as 'stand ready obligations' because they are not accompanied by a conditional obligation.

10. Previously, the Board also observed that, when an entity has a stand ready obligation, the unconditional obligation exists independently of the conditional obligation. The table in paragraph 8 illustrates this point. For example, Retailer's unconditional obligation to provide warranty coverage until 31 May 200Y exists regardless of the likelihood that Customer's product will break down and require repair during the remainder of the warranty period. Similarly, Farmer's unconditional obligation to protect the price and availability of 1000 bushels of corn until 31 May 200Y exists regardless of the likelihood that Canner will exercise the option and require delivery of 1000 bushels of corn for $3 per bushel.

Applying to the hamburger example

11. In the hamburger example, the staff thinks that Vendor does not have a stand ready obligation because paying compensation is not dependent on the occurrence or non-occurrence of an uncertain *future* event. Rather, paying compensation is the potential consequence of an event that has *already occurred*. Using the language in paragraph 7, there is no unconditional obligation associated with a conditional obligation.

12. Instead, in the hamburger example, the staff thinks that Vendor's obligations at inception are two sides of the same coin, as shown in the table below.

	Obligation at inception
Vendor	Sell Customer a hamburger that is fit for consumption. **OR** Compensate Customer for selling a contaminated hamburger.
Retailer	Provide warranty coverage until 31 May 200Y (and complete any repairs resulting from break downs that occurred during the contract period and on or before the balance sheet date). **AND** Repair Customer's product if it breaks down during the remainder of the warranty period.
Farmer	Protect the price and availability of 1000 bushels of corn until 31 May 200Y. **AND** Supply 1000 bushels of corn for $3 per bushel if Canner exercises his option before 31 May 200Y.

13. In the hamburger example, Vendor has already sold the hamburger. Consequently, the staff thinks that the question we need to ask in the hamburger example is: does Vendor have an *unconditional* obligation as a result of selling a contaminated hamburger on or before the balance sheet date that has not yet been reported? In other words, the staff thinks that the fact pattern in the hamburger example is analogous to Retailer's potential IBNR identified in paragraph 9, *not* Retailer's stand ready obligation to provide warranty coverage until 31 May 200Y.

"Contract" status

14. Another way of explaining the difference between the hamburger example and the two examples of stand ready obligations is to look at the "contract" status on the balance sheet date.

	Events prior to the balance sheet date	**Contract status at the balance sheet date**
Vendor	Entered into a non-cancellable “contract” to sell Customer a hamburger that is fit for consumption, or to compensate the customer for selling a contaminated hamburger.	Fulfilled if sold a hamburger that is fit for consumption. Unfulfilled if sold a contaminated hamburger and not yet paid compensation.
Retailer	Entered into a non-cancellable service contract with Customer to provide warranty services until 31 May 200Y. (And to complete any repairs resulting from break downs that occurred during the contract period and before the balance sheet date.)	Part fulfilled. Fulfilled when the warranty period ends and the product does not require repair at that time.
Farmer	Entered into a non-cancellable option contract with Canner to protect the price and availability of 1000 bushels of corn until 31 May 200Y.	Part fulfilled. Fulfilled if Canner does not exercise the option before the expiry date, or Farmer delivers 1000 bushels of corn for $3 per bushel.

15. On the balance sheet date, the staff thinks that the question we need to ask is: has Vendor fulfilled his “contract” with Customer? In the two examples of stand ready obligations there is no doubt that the contracts remain unfulfilled on the balance sheet date and there is still the possibility that an uncertain *future* event may or may not occur. In the hamburger example, there is uncertainty as to whether Vendor has fulfilled his “contract” with Customer on the balance sheet date, but there are no further events to occur.

Do Board members agree that the fact pattern in section A (the hamburger example) illustrates uncertainty about the existence of a present obligation, rather than a stand ready obligation?

C. ALTERNATIVE APPROACHES TO ADDRESSING UNCERTAINTY ABOUT THE EXISTENCE OF A PRESENT OBLIGATION

16. As noted in section B, the staff agrees that the hamburger example illustrates uncertainty about the existence of a present (unconditional) obligation. This section therefore considers how to address that uncertainty.

17. The staff agrees that addressing uncertainty about the existence of a present obligation invariably requires the use of judgment, based on assessing all of the available evidence on the balance sheet date.[3] However, some staff members favour using all of the available evidence to determine whether or not a present obligation exists (View A). Other staff members think that a present obligation exists (View B). They favour using the all of available evidence to reflect uncertainty in the measurement of that present obligation. A third alternative, explained at the end of this Section, is that uncertainty should be taken into account in determining *whether to recognise* a liability, rather than being a factor in determining whether a liability *exists*.

View A – no present obligation exists

18. In the hamburger example, proponents of View A conclude that no present obligation exists because the available evidence does not indicate that Vendor sold a contaminated hamburger. (Although, if material, Vendor might disclose the consequences of selling a contaminated hamburger in the notes his financial statements.) Specifically:

[3] For the purposes of this paper, the evidence available is limited and deliberately simple. In real-life, the staff acknowledges that assessing all of the available evidence on the balance sheet date is likely to involve evaluating the facts and circumstances of the situation, such as: (i) past history of such events occurring; (ii) recent reports on the quality of product and/or its environment; (iii) preventive actions taken by management to manage the risk; and (iv) subsequent events. Developing the content of such guidance will be done in a later stage of the IAS 37 project.

- past experience indicates a very small possibility that Vendor sold Customer a contaminated hamburger. There is no evidence to suggest that it is inappropriate to apply past experience to the current situation.

- in the absence of any evidence to the contrary, it is reasonable to assume that the hamburger was not obviously contaminated at the point of sale (it was not mouldy, for example). Presumably Vendor did not try to sell Customer a contaminated hamburger, and Customer was happy to accept the hamburger offered at the point of sale.

19. Proponents of View A also note that, in March 2007, the Board tentatively concluded that a present obligation exists when (a) an entity is irrevocably committed to act in a particular way and (b) an external party has an enforceable right to call upon the entity to act in a particular way. When applying this tentative conclusion to the hamburger example, proponents of View A particularly emphasise two observations underpinning the Board's tentative conclusion.[4]

Board's previous observation	**Application to the hamburger example**
Operating in a jurisdiction subject to a particular law, by itself, does not give rise to a present obligation.	Operating in a jurisdiction subject to a particular law, by itself, means that Vendor exposes himself to the *risk* that he will be called upon to pay compensation every time he sells a hamburger. But it does not mean that Vendor has a *present obligation* to pay compensation every time he sells a hamburger. Vendor only has a present obligation when he violates that law - i.e., when he sells a *contaminated* hamburger.
A present obligation exists when an external party has an enforceable right to call upon an entity to act in a	Proponents of View A acknowledge that the law in this jurisdiction establishes Customer's right to receive

[4] Paragraph 74 in agenda paper 3B (March 2007) provides a complete list of the observations underpinning the Board's tentative conclusion.

Board’s previous observation	Application to the hamburger example
particular way. In other words, the entity cannot simply walk away from the status quo on the balance sheet date.	a hamburger that is not contaminated, or receive compensation. The law also establishes a mechanism to enforce Customer’s right. However, that mechanism has no effect unless Vendor sold a contaminated hamburger. In other words, Customer does not have an enforceable right to call upon Vendor to pay compensation unless Vendor sold a contaminated hamburger.

20. Proponents of View A acknowledge that it is possible that Vendor did, in fact, sell a contaminated hamburger. However, absent any evidence to support this view, they do not think that it is appropriate to conclude that Vendor has a present obligation. Put another way, Vendor is innocent until proven guilty, rather than guilty until proven innocent.

View B – a present obligation exists

21. Proponents of View B think that a present (unconditional) obligation exists.

22. Supporting their view, proponents of View B think that, on the balance sheet date, there is no uncertainty as to the fact that there is a promise. Once Vendor sells a hamburger he has an unconditional obligation to fulfil that promise—either by selling a hamburger that is fit for consumption or paying compensation if it turns out that the hamburger sold was contaminated. They think that this conclusion is consistent with the Board’s previous observations because: (a) Vendor is irrevocably committed to act in a particular way—that is, to fulfil the promise; and (b) an external party has an enforceable right to call upon the entity to act in a particular way—that is Customer has an enforceable right to call upon the entity to fulfil the promise. Vendor cannot simply walk away from the promise.

23. They acknowledge that there is uncertainty as to whether the hamburger was contaminated at the point of sale; therefore there is uncertainty as to whether the promise has yet been fulfilled. However, they do not find it logical to assume that simply because past experience indicates a very small possibility that Vendor sold a contaminated hamburger, there is *no* present obligation. Rather, they think that a present obligation arises at the point of sale and that present obligation *continues to exist* on the balance sheet date.

24. Proponents of View B also note that Customer would, presumably, also have an asset. Customer is better off by virtue of having purchased a hamburger in a jurisdiction in which laws governing compensation apply, than if it had purchased a hamburger in a jurisdiction without such laws. Indeed, they note that Vendor would almost certainly have to pay, either Customer to release him from the promise, or another party to assume the promise. (Proponents of View A agree with this observation, but argue that Vendor would be paying to mitigate the *risk* that he sold a contaminated hamburger. Paying to mitigate a risk does not confirm or provide evidence that a present obligation exists.)

25. The past experience of selling contaminated hamburgers is not, in the view of those favouring View B, relevant to the assessment of whether a liability *exists*. However, it will be relevant in determining the measurement, and possibly recognition, of that liability.

Applying views A and B

26. In Appendix B the staff applies Views A and B to the fact pattern in section A and briefly considers the implications of each view on recognition and measurement.

27. The purpose of Appendix B is two-fold: (1) to identify clearly the differences between Views A and B; and (2) to understand the potential implications of both views on an entity's balance sheet. The staff is in no way trying to peek ahead(!) or second-guess the outcome of future discussions about recognition and measurement in the IAS 37 and Conceptual Framework projects.

Definition or recognition?

28. Views A and B present the hamburger example as a definitional issue – does a present obligation (an essential characteristic of a liability) exist? This approach is consistent with the approach the Board has taken in the IAS 37 project to date.

29. However, an alternative perspective is that the hamburger example illustrates a recognition issue – should Vendor recognise something to faithfully represent the fact that a present obligation (and a liability) might exist? Presenting the hamburger example as a recognition issue would not change the analysis supporting Views A and B. View A would answer "no, do not recognise something to reflect the fact that a present obligation (and a liability) might exist until the available evidence indicates that Vendor sold a contaminated hamburger". View B would answer "yes, recognise something to reflect the fact that a present obligation (and a liability) might exist; reflect the available evidence in measurement".

D. COMPARATIVE ANALYSIS OF ALTERNATIVES

30. The staff acknowledges that none of the alternatives are ideal.

31. The biggest disadvantage of View A is that it creates a "cliff-hanger": Vendor must decide whether he sold Customer a contaminated hamburger or not. His judgment call might differ from a third party's judgment call based on exactly the same facts. Secondly, Vendor's decision might change if he considers all hamburgers sold, rather than the one hamburger he sold to Customer (a unit of account issue).

32. However, applying View B is likely to significantly increase the number of items that satisfy the definition of a liability. Reflecting all of these liabilities in an entity's balance sheet might obscure decision-useful information. Therefore a cliff-hanger might still be required, albeit at a different point.[5]

[5] For example, the existing IAS 37 has two cliff-hangers: the 'more likely than not' recognition threshold and using individual most likely outcome to estimate single obligations.

33. Consequently one might argue that, from an application perspective, the definition of a liability is the most appropriate place for a cliff-hanger. This is because

(a) creating a cliff-hanger in recognition and measurement may result in an entity omitting from its balance sheet items that satisfy the definition of a liability. This outcome would undermine the recognition principle underpinning the IAS 37 ED and the proposal to eliminate the term 'contingent liability' from IFRS literature.

(b) preparers are likely to incur costs addressing uncertainty about the existence of a present obligation, even at the definition stage (for example, engaging specialists to evaluate the available evidence). However, applying View B, preparers are likely to incur more costs because View B requires a level of numerical precision that is unlikely to be readily available in practice. As noted by one IAS 37 round-table participant (in a slightly different context), the Board is asking preparers to assign probabilities in situations when the least information is available.

34. Alternatively, one could argue that the practicalities in (b) are factors that should be taken into account in setting standards but should not affect the conceptual conclusion that a liability *exists* at the balance sheet date. The staff therefore considered the possibility of following View B in the Conceptual Framework project and View A in the IAS 37 project. The staff does not favour adopting this approach because, in the longer-term, the staff thinks that having a definition of a liability that requires amendment before it can be applied in a general standard about liabilities is wholly unsatisfactory.

Do Board members support View A or View B? Is this for conceptual or practical reasons?

Are there any other arguments Board members would add to the analysis in sections C and D to support either view?

Would Board members' conclusion change if the fact pattern in section A stated that, on or before the balance sheet date, Vendor sold 10,000 hamburgers (all other facts remaining the same)?

Definition or recognition?

35. As noted in paragraphs 28 and 29, an alternative perspective is that the hamburger example illustrates a recognition issue. The recognition principle underpinning the IAS 37 ED is: recognise all items that satisfy the definition of a liability if they can be measured reliably. Recognising something to reflect the fact that a liability *might* exist is inconsistent with this principle. Accordingly, if the Board thinks that the hamburger example illustrates a recognition issue, this principle would require reconsideration.

36. From a practical perspective, the staff questions whether it is necessary to differentiate definition and recognition issues at a standards-level because the conclusions in Views A and B remain unchanged. Therefore, the IAS 37 project staff favour continuing to present the hamburger examples as a definitional issue for purposes of that project.

37. However, the staff is interested in understanding whether the Board thinks that the hamburger example illustrates a recognition issue, rather than a definition issue. If so, should the staff explore that approach further as part of the Conceptual Framework project, the IAS 37 project, or both?

Do Board members think that the hamburger example illustrates a definition or recognition issue?

If Board members think that it illustrates a recognition issue, would the Board like to explore this approach as part of the Conceptual Framework project, the IAS 37 project, or both?

E. NEXT STEPS

IAS 37 project

38. The staff proposes using the analysis in section B of this paper to simplify our description of a stand ready obligation (tentatively agreed in March 2007) to read:

> "a stand ready obligation describes an unconditional obligation associated with a conditional obligation." ~~present obligations whereby an external party has a right to call upon the entity to act in a particular way in the future, but either the circumstances entitling the external party to exercise its right may not arise, or the external party may choose not to exercise its right."~~

39. The staff plans to use the Board's conclusions on sections C and D of this paper when developing draft indicators to assist an entity in addressing uncertainty about the existence of a present obligation. (The Board affirmed its plan to consider draft indicators after reflecting on the outcome of the IAS 37 round-table discussions.[6]) The staff thinks that we will need to consider draft indicators following any of the alternatives.

Conceptual framework project

40. The staff plans to use the analysis in this paper in its explanation of the distinction between a liability and a business risk, thus helping to establish the boundaries of what constitutes a liability, in the conceptual framework project.[7] The thinking will also be useful in considering recognition.

41. To date, this analysis has been discussed only by the IASB. However, the staff plan to consolidate both the March and May papers and bring them to the FASB for discussion in the context of the conceptual framework project in June.

[6] See agenda paper 4B discussed in January 2007.
[7] The analysis will also help distinguish an asset from a business opportunity.

F. SUMMARY: WHAT HAVE WE LEARNED SO FAR?

Distinguishing a business risk from a liability

42. In March 2007, the Board considered a series of examples, which demonstrated that not all business risks give rise to liabilities. At that time, the Board tentatively concluded that the key differentiating factor is that **a present obligation is an essential characteristic of a liability, but not a business risk**. That is, the existence of a present obligation distinguishes a liability from a business risk. The Board noted that a business risk might exist on the balance sheet date and an entity might become obligated in the future as a result of that risk, but an entity is not *presently* obligated as a result of a business risk on the balance sheet date. This is because an entity can choose to take action to avoid or mitigate the impact of a risk.

43. The Board continued to tentatively conclude that **a present obligation exists when (a) an entity is irrevocably committed to act in a particular way, and (b) an external party has an enforceable right to call upon the entity to act in that particular way**. Consequently:

- **an irrevocable action or event, by itself, does not give rise to a present obligation**. A mechanism that establishes an external party's right to call upon the entity is also required.
- **a law (including contract law) or regulation, by itself, does not give rise to a present obligation**; an irrevocable action or event is also required. However, laws and regulations are examples of mechanisms that may establish an external party's right to call upon the entity to act in a particular way.
- **a revocable (non-binding) action or event** in a jurisdiction where there is a mechanism that establishes an external party's right to call upon the entity to act in a particular way **does not give rise to a present obligation**.

- **planning a future irrevocable action or event** in a jurisdiction where there is a mechanism that establishes an external party's right to call upon the entity to act in a particular way **does not give rise to a present obligation**.

44. In other projects, such as the joint IASB/FASB Revenue Recognition project, the Boards have observed that contractual promises may be:

    (a) *Conditional*—Performance is subject to an event that is not certain to occur.

    (b) *Unconditional*—Nothing other than the passage of time is necessary for performance to occur.

    (c) *Mature*—Performance is not subject to any event, including the passage of time.[8]

45. Contracts comprise a promisor, a promisee and a promise. Using terminology from the joint Conceptual Framework project, the promise is what creates an economic burden or an economic resource; the promisor is the party obligated by the promise; and the promisee is the party that has rights in accordance with the promise. Thus, a shorthand way of referring to the above promises, and a way that is frequently used, is to refer to the promisor as having a conditional, unconditional, or mature obligation.

46. In the context of the Conceptual Framework project, the Boards have concluded that, in the context of the asset definition, inbound contractual promises that are conditional are not present economic resources because their performance is not presently required. Thus, it follows that in the context of the liability definition, outbound contractual promises that are conditional would not be economic burdens because their performance is not presently required—performance is due only if and when the uncertain future event occurs. However, contractual promises that are unconditional or mature (that is, non-conditional) may qualify as

[8] This terminology is derived from contract law.

present economic resources/burdens because their performance is presently required.[9]

47. Therefore, **conditional contractual promises do not give rise to a present obligation**. We think that the same can be said for conditional non-contractual promises.

Stand ready obligations

48. Even though a conditional promise does not give rise to a present obligation, there might be an associated unconditional promise that does give rise to a present obligation. The Board has described such an unconditional obligation that is associated with a conditional obligation as a *stand ready obligation.*

49. In March 2007, the Board clarified that the notion of a stand ready obligation describes present obligations whereby an external party has a right to call upon the entity to act in a particular way in the future, but either the circumstances entitling the external party to exercise its right may not arise, or the external party may choose not to exercise its right.

In this paper we go on to clarify further that a stand-ready obligation describes "an unconditional obligation associated with a conditional obligation." ~~present obligations whereby an external party has a right to call upon the entity to act in a particular way in the future, but either the circumstances entitling the external party to exercise its right may not arise, or the external party may choose not to exercise its right."~~

50. In March 2007, the Board noted that because statutes and contracts are simply legal mechanisms that establish an external party's right to call upon the entity to act in a particular way, the form of the mechanism (i.e., statute or contract) should not influence whether a stand ready obligation exists. As a result, the Board tentatively affirmed that **the notion of a stand ready obligation can apply to both contractual and non-contractual scenarios.**

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9 Later in the Conceptual Framework project, we will assess whether a "concurrently conditional promise" gives rise to assets and liabilities. A *concurrently conditional promise* is one where the performance of one promise is subject to the performance of the other exchanged promise— both parties must perform at the same time.

51. In March 2007, the Board also expressed the view that a short-hand term capturing the long-hand explanation of a ‘stand ready obligation’ was helpful. The Board tentatively decided to keep the term but asked the staff to consider other phrases or terms when drafting the standard.

Does the Board agree with the forgoing conclusions?

Yet to resolve

52. This paper considers whether uncertainty about the existence of a present (unconditional) obligation should be taken into account in determining whether or not a present obligation exists (View A in this paper) or in the measurement of that obligation (View B in this paper). That is, does uncertainty relate to the existence of a business risk, rather than a liability—or is it part of measuring a liability? Alternatively, it considers whether uncertainty should be taken into account in recognition, rather than existence.

APPENDIX A: Reconciling back to the fact pattern previously discussed by the Board

A1. The Board first discussed the hamburger example in March 2007 (Example 3B in agenda paper 3B) using the following facts:

> 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.
>
> On 31 December 200X, Vendor has sold one hamburger to Customer. Customer has eaten the hamburger, but is not hospitalised.

A2. The fact pattern used in this paper (section A) removes the second event: Customer is entitled to compensation if Vendor sells a contaminated hamburger, regardless of whether Customer is hospitalised as a result of eating a contaminated hamburger.

A3. In a two-event scenario, proponents of View A would conclude that a present obligation exists only when both conditions are satisfied – i.e., when the available evidence indicates that Customer will be hospitalised as a result of eating a contaminated hamburger. If there is absolutely no doubt that Vendor sold Customer a contaminated hamburger, proponents of View A would consider the likelihood that Customer will be hospitalised before concluding that a present obligation exists.

A4. In a two-event scenario, proponents of View B would continue to conclude that a present obligation exists from the point of sale. Uncertainty about both events would be captured in the measure of that present obligation. If there is absolutely no doubt that Vendor sold Customer a contaminated hamburger, the likelihood that Customer will be hospitalised will affect the measurement of Vendor's present obligation, but not the conclusion that a present obligation exists.

A5. In March 2007, some Board members argued if there is absolutely no doubt that Vendor sold Customer a contaminated hamburger, Vendor has a present (stand ready) obligation regardless of the likelihood that Customer will be hospitalised. The staff agrees that hospitalisation is an uncertain future event.

However, the staff does not agree that the two-event scenario gives rise to a stand ready obligation. First, this is because hospitalisation does not fit the description of a conditional obligation. Rather, hospitalisation is the potential consequence of eating a contaminated hamburger, an event that has already occurred. Secondly, on the balance sheet date, the question remains: has Vendor fulfilled his "contract" with Customer?

A6. Proponents of View A would also note that, unless Customer is hospitalised as a result of eating the contaminated hamburger, he does not have an enforceable right to call upon Vendor to pay compensation.

A7. Some might also argue that, as a result of operating in a jurisdiction subject to a particular law, Vendor has an unconditional obligation to sell Customer hamburger that is fit for consumption, and a conditional obligation to pay compensation if Customer is hospitalised as a result of eating a contaminated hamburger. Thus, Vendor could have a stand ready obligation. Proponents of View A and B disagree with this analysis. As written, the law does not require the Vendor to provide assurances to the customer for a period of time or to stand ready to compensate customers. The law requires the Vendor to compensate the customer when a contaminated burger is sold (View B) and results in the customer being hospitalised (View A).

A8. For those who might view the simplified example discussed in this paper as a recognition issue, rather than one of definition, we note that the original example does introduce definitional issues, in that a decision is necessary as to whether only one, or both, event(s) is/are necessary in order for a liability to *exist*.

APPENDIX B: Applying Views A and B

B1. This appendix applies Views A and B to the fact pattern in section A and briefly considers the implications of each view on recognition and measurement. The purpose of this appendix is two-fold: (1) to identify clearly the differences between Views A and B; and (2) to understand the potential implications of both views on an entity's balance sheet.

View A

Liability definition

B2. Using only the limited facts given in section A, proponents of View A conclude that no liability exists. Consequently, there is no need to consider recognition and measurement.

B3. However, if, on the balance sheet date, there is other evidence indicating that Vendor sold a contaminated hamburger, proponents of View A would agree that a present obligation exists. (For example, if there is evidence that seventy-five of the one hundred hamburgers sold on the same day as Customer's hamburger were contaminated.)

B4. Proponents of View A would then move on to consider the second essential characteristic of a liability: an expected outflow of economic benefits. In this example, there is some expectation/capability of an outflow of economic benefits because the law requires Vendor to pay compensation to every customer who purchases a contaminated hamburger. Consequently, proponents of View A would conclude that a liability exists.[10]

Recognition

B5. The recognition principle underpinning the IAS 37 ED is an entity shall recognise all items that satisfy the definition of a liability, if they can be

[10] In May 2006, the Board tentatively concluded that the phrase 'expected to' in the definition of a liability does not require a particular degree of certainty that an outflow of economic benefits will occur before the definition of a liability is satisfied. This tentative conclusion is the starting premise for this paper.

measured reliably.[11] Applying this principle, proponents of View A would conclude that Vendor should recognise a liability.

Measurement

B6. The IAS 37 ED proposes using expected value to measure all liabilities.[12] Applying expected value, Proponents of View A would reflect all known information about the outflow of economic benefits required to settle Vendor's liability in measurement. For example, if it is highly likely that Customer will claim compensation, Vendor would have a larger liability than if there is a low likelihood that Customer will claim compensation.

B7. It is important to note that proponents of View A would not reflect the 25% chance that Vendor did not sell the customer a contaminated hamburger in measuring his liability because that information relates to the non-liability scenario, not the liability scenario.[13]

View B

Liability definition

B8. Proponents of View B conclude that a present obligation exists. Also, there is some expectation/capability of an outflow of economic benefits; therefore, a liability exists. It does not matter how likely it is that Vendor sold a contaminated hamburger. Other evidence that makes the sale of a contaminated hamburger more or less likely does not affect the existence of a liability—although it might affect its recognition or measurement.

Recognition

B9. Applying the recognition principle underpinning the IAS 37 ED, proponents of View B would conclude that Vendor should recognise a liability. However, proponents of View B acknowledge that there might be practical difficulties.

[11] In the IAS 37 project, the Board has agreed to consider whether there are practical limitations to recognising all items that satisfy the definition of a liability at a future meeting. Recognition is a separate step in phase B of the Conceptual Framework project.

[12] In the IAS 37 project, the Board has agreed to consider the proposed measurement principle in the IAS 37 ED at a future meeting. Measurement is a separate phase of the Conceptual Framework project.

[13] For example, if it is 90% likely that Customer will claim compensation, the expected value is £90,000. It is not £67,500 (75/100 hamburgers x 90% of £100,000).

Therefore, at a standards level, there might be reason to impose a practical recognition threshold. Such practicalities are discussed in paragraphs 32 to 34 of this paper.

Measurement

B10. Proponents of View B would take the past history of selling contaminated hamburgers, as well as any other evidence about the likelihood that contaminated hamburgers have been sold, into account in the measurement of the liability. If Vendor has a poor past history of selling contaminated hamburgers, then Vendor would have a larger liability than if its past history were more favourable.

Similarities and differences

B11. Views A and B are similar in that they both focus on the existence of a present obligation before turning to recognition and measurement. However, View A concludes only that a present obligation exists after reviewing all evidence available. In contrast, View B concludes that a present obligation arises from every hamburger sold. The table below (at the most simplistic level) illustrates the similarities between the two Views.

<table>
<tr><th>Chain of events</th><th colspan="2">Vendor’s obligations</th><th>Customer’s obligations</th></tr>
<tr><td>Customer asks Vendor to sell him a hamburger for £x.

(Assume Customer’s offer is not binding until accepted.)</td><td colspan="2">No unconditional obligation because Vendor can refuse to sell Customer a hamburger for £x.</td><td>No unconditional obligation to purchase a hamburger because this offer is not binding until accepted.</td></tr>
<tr><td>Vendor agrees.</td><td colspan="2">Conditional obligation to sell Customer a hamburger that is fit for consumption, or pay compensation.</td><td>Unconditional obligation to pay Vendor £x because the contract is binding once accepted.</td></tr>
<tr><td>Customer pays Vendor £x.</td><td colspan="2">Unconditional obligation to sell Customer a hamburger that is fit for consumption, or pay compensation.</td><td>No further obligation. Unconditional obligation to pay Vendor £x is extinguished.</td></tr>
<tr><td>Vendor delivers the hamburger to Customer.</td><td><u>View A</u>
Unconditional obligation to sell Customer a hamburger that is fit</td><td><u>View B</u>
Unconditional obligation to sell Customer a hamburger that is fit</td><td>No further obligation.</td></tr>
</table>

Chain of events	Vendor's obligations		Customer's obligations
	for consumption, or pay compensation ***is extinguished***, unless the available evidence suggests otherwise.	for consumption, or pay compensation ***continues***, unless the available evidence suggests otherwise.	

B12. The differences in recognition and measurement and the implications on an entity's balance sheet all stem from this different approach to addressing uncertainty about the existence of a present obligation, as summarised below.

	View A		**View B**	
	1/1,000,000 contaminated	*75/100 contaminated*	*1/1,000,000 contaminated*	*75/100 contaminated*
Definition – present obligation	No	Yes	Yes	Yes
Definition – outflow of economic benefits	N/a	Yes	Yes	Yes
Recognition	N/a	Yes	Yes	Yes
Measurement	N/a	Yes	Yes	Yes