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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: 17 May 2007, London

Project: Liabilities - amendments to IAS 37

Subject: Constructive obligations (Agenda Paper 8)

INTRODUCTION

1. The IAS 37 project has two objectives. The first objective is to analyse items within the scope of IAS 37 in terms of assets and liabilities, as defined by the *Framework*. The second objective is to converge the guidance on recognising restructuring costs in IAS 37 with the guidance in SFAS 146 *Accounting for Costs Associated with Exit or Disposal Activities*. Constructive obligations straddle both project objectives.
2. The purpose of this paper is to identify and consider issues associated with the proposed amendments to the definition of a constructive obligation and the explanatory text in the IAS 37 ED. The staff is also seeking guidance from the Board on how to reconcile the proposed amendments affecting constructive obligations with other tentative conclusions reached by the Board during redeliberations.

3. The paper divides into the following sections:
 - A. Re-capping the proposed amendments in the IAS 37 ED
 - B. Comment letter analysis
 - C. What makes a constructive obligation an *obligation*?
 - D. The dividing line between legal and constructive obligations
 - E. More guidance on constructive obligations

A. RE-CAPPING THE PROPOSED AMENDMENTS IN THE IAS 37 ED

Background

4. The FASB issued SFAS 146 in June 2002, replacing EITF 94-3 *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit An Activity (including Certain Costs Incurred in a Restructuring)*. Since EITF 94-3 and IAS 37 contained similar guidance on restructuring costs SFAS 146 created a new IFRS-US GAAP difference. SFAS 146 and IAS 37 interpret *when* an entity has a present obligation for restructuring costs differently.¹

What makes a constructive obligation an *obligation*?

5. After analysing the rationale underpinning the guidance in SFAS 146, the Board concluded that IAS 37 misapplies the definition of a constructive obligation. The Board reasoned that announcing a restructuring plan in a general way does not give rise to a present obligation because an entity could subsequently recall the plan, thereby avoiding an outflow of economic benefits.²
6. More generally, the Board was concerned that the standard's definition of a constructive obligation could be interpreted too broadly and admit items that do not satisfy the *Framework's* definition of a liability. This is because IAS 37

¹ IAS 37, paragraphs BC BC52-BC54. See also SFAS 146, paragraph B61.

² IAS 37, paragraph BC68.

currently differentiates constructive obligations from legal obligations, but does not explain what makes a constructive obligation an *obligation* - ie something an entity cannot avoid. The Board therefore considered limiting the recognition of constructive obligations to those that a court would enforce. However, the Board concluded that it would be inappropriate to make this kind of amendment without reconsidering liabilities and constructive obligations more generally.³

7. As a result, the Board decided to limit its amendments to emphasising that a constructive obligation involves an obligation to others by introducing the phrase 'reasonably rely on' into the definition of a constructive obligation and inserting new explanatory text.
8. The proposed definition of a constructive obligation reads:

A constructive obligation is ~~an~~ present obligation that arises ~~derives~~ from an entity's past actions when ~~where~~:

- (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 certain responsibilities; and
- (b) as a result, the entity has created a valid expectation in ~~on the part of~~ those ~~other~~ parties that they can reasonably rely on it ~~will~~ to discharge those responsibilities.

The following new text in paragraph 15 of the IAS 37 ED supports that definition:

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 be the case only 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.

³ IAS 37, paragraphs BC58-BC60. .

The dividing line between constructive and legal obligations

9. The Board also noted that separately defining legal and constructive obligations in IAS 37 sometimes causes confusion because many constructive obligations are legally enforceable.⁴
10. For example, a commonly accepted example of a constructive obligation is a retailer with an established and well-known history of refunding dissatisfied customers, even though there is no explicit law or regulation requiring him to do so. (IAS 37 and the IAS 37 ED both use this example.) In some jurisdictions, a court might determine that, based on past practice, there is an implied contract between the retailer and his customers with respect to refunds. Consequently, in these jurisdictions, this commonly accepted example of a constructive obligation is legally enforceable.⁵
11. The Board also noted that, in some jurisdictions, ‘constructive obligation’ is a defined *legal* term. For example, *Black’s Law Dictionary* defines constructive as ‘legally imputed; having an effect in law though not necessarily in fact’. In these jurisdictions constructive obligations are a subset of legal obligations, not a separate class of obligations.
12. Therefore, the IAS 37 ED proposes softening the dividing line between legal and constructive obligation by inserting new text (paragraph 14) to explain that some items described as constructive obligation are legally enforceable:

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

⁴ October 2004, agenda paper 7, paragraphs 12-20.

⁵ For example, in the US, a court may use the doctrine of promissory estoppel to confirm that the retailer has a legal obligation. Similarly, in *some* situations, a French court may conclude that a ‘quasi-contract’ exists and a UK court may conclude that a well-known, generous refunds policy is enforceable through the Trade Descriptions Act or the Advertising Standards Authority.

promissory estoppel or principles having the same effect under other legal systems. (emphasis added)

B. COMMENT LETTER ANALYSIS

Definition

13. All respondents who commented on this aspect of the IAS 37 ED agreed that a constructive obligation must satisfy the *Framework's* definition of a liability. But a majority asked the Board to explain how inserting the phrase 'reasonably rely on' into the definition of a constructive obligation meets the Board's objective. Specifically:
- (a) some respondents argued that inserting the phrase 'reasonably rely on' into the definition of a constructive obligation is meaningless and is unlikely to have any effect in practice. This is because the proposed amendment is a tautology. To create a valid expectation, other parties must be able to reasonably rely on the entity to discharge its responsibilities.
 - (b) other respondents asked the Board clarify the extent of the change proposed in the ED by giving examples of items previously described as constructive obligations that would no longer be recognised because the item does not satisfy the definition of a liability.
 - (c) a few challenged the Board's decision not to introduce legal enforceability. These respondents noted that introducing legal enforceability would improve consistency by removing any doubt about when and why a present obligation exists and would achieve greater convergence with US GAAP. (The staff notes that most of these respondents challenged the Board's decision without explicitly stating that they would support introducing legal enforceability. In fact, some explicitly stated the opposite: they would *not* support legal enforceability.)

14. A minority of respondents opposed amending the definition of a constructive obligation. These respondents argued that there is insufficient diversity in practice to justify change.

Explanatory text

15. A majority of respondents agreed the explanatory text proposed in the IAS 37 ED is appropriate and helpful. Several added that the proposed text more effectively meets the Board's objectives than inserting the phrase 'reasonably rely on' into the definition of a constructive obligation.
16. However, some respondents requested more guidance. Most of these respondents asked for guidance on the type of communication required before another entity can 'reasonably rely on' an entity's actions.

Other

17. Appendix A summarises the other comments received in relation to the proposed amendments to constructive obligations and includes a staff response to each comment. The staff does not propose discussing Appendix A at this meeting unless a Board member has a specific question or disagrees with the staff response.

C. WHAT MAKES A CONSTRUCTIVE OBLIGATION AN *OBLIGATION*?

18. The staff agrees that the difference between a 'valid expectation' and a 'valid expectation that an external party can reasonably rely on' is very subtle and does not clearly explain what makes a constructive obligation an *obligation* – ie something an entity cannot avoid. In this respect, constituents' comments are consistent with some Board members' concerns prior to issuing the ED.
19. On three separate occasions the Board discussed clarifying this point by limiting the recognition of constructive obligations to those that a court would enforce

before issuing the IAS 37 ED.⁶ Ultimately, the Board decided against this approach. However, the staff believes that it is appropriate to reconsider this option in light of the comment letters received, the Board’s recent discussions on distinguishing a liability from a business risk, and the Board’s discussions on constructive obligations in the Conceptual Framework project.

Re-capping previous discussions

Arguments in favour

20. The idea of limiting the recognition of constructive obligations to those that a court would enforce comes from US GAAP. SFAS 143 *Accounting for Asset Retirement Obligations* uses ‘promissory estoppel’, a legal principle that protects an external party’s reliance on a promise by enforcing promises that are not supported by consideration and oral promises that ordinarily would be required to be in writing.⁷ Consequently the Board noted that, applying SFAS 143, a constructive obligation would be recognised only if a court would enforce an entity’s promise.
21. The Board noted that limiting the recognition of constructive obligations to those that a court would enforce would establish a clearer benchmark against which preparers and auditors could assess each item. A clearer benchmark is likely to improve consistency in applying the notion of a constructive obligation. Indeed, this was the conclusion the FASB reached when redeliberating SFAS 143, explaining:

“...To achieve more consistent application of this Statement, the Board decided that only existing legal obligations, including legal obligations under the doctrine

⁶ Agenda paper 9A discussed in December 2002, agenda paper 9A discussed in May 2003 and agenda paper 7 discussed in October 2004.

⁷ IAS 37 ED, paragraph BC58. *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 to his or her detriment.” Some jurisdictions may use other terms to describe the same idea, for example ‘quasi-contract’.

Paragraph A4 of SFAS 143 gives an example of a situation when an entity may need to consider applying promissory estoppel.

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.”⁸

Arguments against

22. Despite some support, the Board previously decided *against* limiting the recognition of constructive obligations to those that a court would enforce in the IAS 37 ED. In reaching this conclusion, the Board noted that this approach:
- (a) is inconsistent with the amplifying text supporting the definition of a liability in the current IASB *Framework*. Specifically, paragraph 60 states that legal enforceability is not a prerequisite for a liability: “... Obligations may be legally enforceable ... Obligations also arise, however, from normal business practice, custom and a desire to maintain good business relations ...”
 - (b) would have a significant effect on the accounting guidance for some liabilities within the scope of IAS 19 *Employee Benefits*. For example, paragraph 52 of IAS 19 *Employee Benefits* states: “An entity shall not only account for its legal obligation under the formal terms of a defined benefit plan, but also for any constructive obligation that arises from the entity’s informal practices”
 - (c) is likely to be perceived as a significant conceptual change that is beyond the scope of this project. This is because this approach is not only a significant step away from the current IASB *Framework*, but also the frameworks of other national standard setters (see appendix B)

The staff believes that these arguments remain valid.

23. Furthermore, the staff notes that limiting the recognition of constructive obligations to those that a court would enforce may be perceived as inconsistent with the recognition principle underpinning the IAS 37 ED (namely, to recognise

⁸ SFAS 143, paragraph B16.

all items that satisfy the definition of a liability if they can be measured reliably) and the direction the Board is tentatively pursuing in its Conceptual Framework project.

Distinguishing a liability from a business risk

24. Distinguishing a liability from a business risk has been a specific area of focus during the redeliberations phase of this project. The staff considers that the outcome of these redeliberations presents a new challenge for the Board with regards to constructive obligations.

Background

25. In March 2007, the Board tentatively concluded that a present obligation is an essential characteristic of a liability, but not a business risk. A present obligation exists when an entity is irrevocably committed to act in a particular way and an external party has **an enforceable right** to call upon the entity to act in that particular way. When drafting the tentative description of a present obligation the staff deliberately stopped short of stating ‘... an external party has a *legally* enforceable right ...’.⁹
26. The IAS 37 ED defines a constructive obligation as a ‘*present* obligation that arises from an entity’s past actions ...’.¹⁰ Logically, therefore, all items described as constructive obligations should be consistent with the Board’s tentative description of a present obligation. In other words, a constructive obligation is only a present obligation when an external party has an *enforceable right* to call upon the entity to act in a particular way.

⁹ The staff acknowledges that, when translated into some languages, ‘enforceable’ is a legal term. Going forward, we may need to find another English word to use in this description without changing the intended meaning. Synonyms suggested in the Merriam-Webster On-line Thesaurus and Roget’s New Millennium Thesaurus include compel, carry out effectively, urge with energy, justifiable, precedented, sanctioned and valid.

¹⁰ The word ‘present’ was inserted in the IAS 37 ED. The current standard defines a constructive obligation as ‘an obligation that derives from an entity’s actions ...’

27. The new challenge is reconciling the tentative description of a present obligation with the Board's previous discussions about enforceability in the context of constructive obligations.
28. The staff has identified a number of options for the Board to consider. All of the options identified require further thought and development. Therefore the staff is not asking the Board to make any decisions at this meeting. Rather, the staff is seeking direction from the Board on which (if any) of the options it should explore further.

Option 1 – limit constructive obligation to those that a court would enforce

29. Paragraph 60 of the *Framework* does not restrict the description of a present obligation to legally enforceable obligations. Therefore the first option is to admit that some constructive obligations may be present obligations even though they are not legally enforceable but, at the standards level, restrict the *recognition* of constructive obligations in IAS 37 to those that a court would enforce.¹¹ Option 1 is similar to the SFAS 143 approach.
30. Paragraphs 20-23 outline the arguments for and against this option.

Option 2 – enforceable by equivalent means

31. Option 2 is to consider amending the tentative description of a present obligation to explain that an external party may have a right that is 'enforceable by legal *or equivalent means*'.
32. The staff thinks that simply introducing the phrase 'enforceable by equivalent means' without further explanation would be unacceptable to many because it immediately begs the question "what does 'enforceable by equivalent means' mean?". However, identifying those items that satisfy the definition of a

¹¹ This could be achieved by (i) excluding constructive obligations that a court would not enforce from the scope of any final standard, or (ii) including an exception to the recognition principle underpinning the ED.

constructive obligation but are not legally enforceable, and then considering whether they are enforceable by equivalent means is likely to be a difficult task.

33. In the context of the Conceptual Framework project the Board has observed that the exchanges in many wholesale diamond markets or other commodity markets are agreed based on oral discussions or non-verbal signals. A court may not enforce obligations created under these circumstances, but the informal rules and regulations of the trading organisation remove the trader's discretion to avoid his obligation.¹² Arguably, this observation goes some way towards explaining 'enforceable by equivalent means'.
34. However, the Board's deliberations in the Conceptual Framework project are incomplete. The IAS 37 project is also operating on a shorter timescale than the Conceptual Framework project. Therefore the staff (regrettably) believes that we cannot "park" this issue pending further progress in the Conceptual Framework project.
35. [Paragraph omitted from observer notes]

Option 3 - use the explanatory text already in paragraph 15 of the IAS 37 ED as a proxy for explaining 'enforceable by equivalent means'.

36. Option 3 is really an extension of option 2 that looks for an (albeit imperfect) way to explain 'enforceable by equivalent means' [using the text already in the ED]. For example, following this option, paragraphs 13 and 15 of the IAS 37 ED could be amended to read something along the lines of:

13 An essential characteristic of a liability is that the entity has a present obligation arising from a past event. A present obligation exists when the entity is irrevocably committed to act in a particular way and an external party has an enforceable right to call upon the entity to act in that particular way. An external party's right may be enforceable by legal or equivalent means. ~~For a past event to give rise to a present obligation, the entity must have little, if any, discretion to avoid settling it.~~ A past event

¹² Agenda paper 9A discussed in February 2006 and agenda paper 8A discussed in April 2006. Agenda paper 8A was also discussed jointly with the FASB in the Joint IASB/FASB meeting in April 2006.

that creates a present obligation is sometimes referred to as an obligating event.

14

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 be the case only 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.

37. However, some may question whether it is appropriate to use the language in paragraph 15 to explain the meaning of 'enforceable by equivalent means'. As it currently stands, the intention of paragraph 15 is to emphasise that a constructive obligation involves an *obligation* to others because an external party can 'reasonably expect' the entity to act in a particular way (thereby linking paragraph 15 to the phrase 'reasonably rely on' inserted into the definition of a constructive obligation). This is quite different to emphasising that a constructive obligation involves an obligation to others because an external party has an 'enforceable right' – the latter is a much stronger notion.

Option 4 – continue developing the Board's tentative description of a present obligation in the Conceptual Framework project but drop the description in the IAS 37 project.

38. The staff does not favour this option because both the Board and most round-table participants agree that distinguishing between a liability and a business risk is critical step in the IAS 37 project. Dropping the description of a present obligation in the IAS 37 project may result in an entity recognising as a liability an item that is, in fact, a business risk.

39. Moreover, albeit imperfectly, ‘enforceable by equivalent means’ goes some way towards explaining that a constructive obligation is an *obligation* - ie something an entity cannot avoid.

Option 5 - revisit the Board’s tentative conclusions in March to see whether it is possible to distinguish a liability from a business risk without introducing the idea of enforceability.

40. The staff does not favour this option because for some time the Board has observed that a present *obligation* is something an entity cannot avoid. In other words, enforceability is already implicit in the definition of a liability. Recent work in the context of both the Conceptual Framework and the IAS 37 projects has confirmed this view. [Remainder of paragraph deleted from the observer notes.]

Conclusion

41. At first glance, the staff does not find any of these options wholly satisfactory. However, the staff thinks that options 1, 2 and 3 are the only viable options.
42. The staff notes that further exploring any of these options will involve considering the illustrative examples of constructive obligations accompanying the ED and the potential impact on IAS 19. For reference, appendix C identifies the relevant sections of IAS 19.

Does the Board agree that we need to reconcile ‘enforceable right’ in the tentative description of a present obligation and the definition of a constructive obligation as part of redeliberations?

If so, which of the identified options would the Board like the staff to explore further?

Does the Board have any other options they would like the staff to explore?

D. THE DIVIDING LINE BETWEEN LEGAL AND CONSTRUCTIVE OBLIGATIONS

43. Both IAS 37 and the IAS 37 ED separately define legal and constructive obligations. This could be read imply that there is a clear dividing line between legal and constructive obligation – either an item is a legal obligation or it is a constructive obligation, it cannot be both. However, the new text proposed in paragraph 14 of the ED seeks to soften this dividing line by explaining that many constructive obligations are legally enforceable.
44. Whilst a majority of respondents supported the new text proposed in the ED, many also questioned how the proposed amendments meet the Board’s objectives. This section therefore considers two further steps the Board could take to soften the dividing line between legal and constructive obligations and explain that many constructive obligations are legally enforceable. The staff thinks the analysis in this section of the paper is relevant, regardless of the Board’s conclusions on sections C.

Meaning of ‘legally enforceable’

45. This section starts by considering the meaning of ‘legally enforceable’. This is because the comment letters and other feedback received suggest (but do not state) that different views may exist.
46. Some seem to have a narrow view, capturing only those items explicitly covered by statute or law. Others seem to have a wider view, capturing all items with some legal foundation. Examples of items considered legally enforceable by those following the wider view (but not by those following the narrower view) might include self-regulatory bodies with delegated authority and officially recognised trade association codes such as the UK Law Society which has delegated authority to make practice rules for solicitors and the General Medical Council which has similar authority for doctors. Another example is the Financial Services Act 1986 which recognised the Securities and Investments Board (now

the FSA) and self-regulatory organisations such as the Personal Investment Authority and the Investment Management Regulatory Authority.¹³

47. The Board's discussions before issuing the IAS 37 ED (see section A), the definition of a legal obligation and the Board's tentative conclusions in other projects all suggest that the Board follows the wider view. For example,
- (a) the current definition of a legal obligation includes 'other operation of law' (although IAS 37 does not explain what this phrase means), and
 - (b) in the revenue recognition project, the Board's tentative conclusions on contractual rights and obligations capture informal oral agreements as well as formal written agreements. In many jurisdictions, both types of contract would be captured by contract law.
48. The staff believes that clarifying the meaning of 'legally enforceable' would further soften the dividing line between legal and constructive obligations. It would also limit the number of items within the 'enforceable by equivalent means' category discussed in section C.
49. The staff considers that the Board could clarify the meaning of 'legally enforceable' by amending either the definition of a legal obligation, or the text in paragraph 14 of the IAS 37 ED (or a combination of the two). For example, the definition of legal obligation could be amended to read something along the lines of:

A legal obligation is a present obligation that arises from one or more of the following:

- (a) the explicit or implicit terms of a contract. In the context of this Standard, a contract is an agreement between two or more parties that a court would enforce. Examples include formal written agreements and informal oral agreements. (through its explicit or implicit terms);
- (b) legislation. Examples include laws established by statute and regulation.

¹³ Examples sourced from *Models of Self-Regulation: An overview of models in business and the professions*, published by the National Consumer Council (UK), November 2000.

- (c) laws and contracts interpreted using precedent established in a particular jurisdiction.
- (ed) other operation of law. In the context of this Standard, other operation of law captures all items with some legal foundation. Examples include self-regulatory bodies with delegated authority granted by legislation or contract and trade association codes that have been recognised through legislation or contract.

Alternatively paragraph 14 of the IAS 37 ED could be amended to read something along the lines of:

- 14 Because most liabilities arise from legal obligations, settlement can be enforced by a court. In the context of this Standard, legal obligations include all items with some legal foundation. Examples include oral contracts, self-regulatory bodies with delegated authority granted by legislation or contract and trade association codes that have been recognised through legislation or contract.

Explanatory text rather than definitions

- 50. In this section the staff considers taking one further step towards softening the dividing line between legal and constructive obligations: using the definition wording as explanatory text in any final standard rather than as defined terms. At this point the staff would like to emphasise that this involves *moving* the definitions of legal and constructive obligations, not *removing* the definitions.

Unnecessary duplication with the Framework

- 51. As noted above, paragraph 60 in the *Framework* does not restrict present obligations to legally enforceable obligations. Arguably, therefore, there is no need to separately define legal and constructive obligations at a standards level. As shown in Appendix B, many national standard-setters define or describe legal and constructive obligations in their framework (for example, Australia, Canada and the UK). The Conceptual Framework project too is exploring this approach. Moreover, defining legal and constructive obligations at a standards level may be considered inappropriate because standards other than IAS 37 (such as IAS 19) apply the terms.

52. Admittedly, the general description of present obligations in paragraph 60 of the *Framework* is not as specific as the definitions in IAS 37. In fact, the *Framework* does not even use the term ‘constructive obligation’. As a result, some might argue that the Board should not remove the IAS 37 definitions without defining or describing constructive obligations in the *Framework* first (especially as the terms are used in other standards). In other words, the Board should consider this step as part of the Conceptual Framework project but, in the meantime, retain legal and constructive obligations as defined terms in IAS 37.

53. However, the staff believes that the Board could overcome this argument by using the current definition of a constructive obligation in the explanatory text. For example, paragraph 15 could be amended to read something along the lines of:

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 be the case only if:

- (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;
- (b) as a result the entity has created a valid expectation in the other parties that they can reasonably rely on ~~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.

Such items are often described as ‘constructive obligations’.

54. The staff also notes that the text taken from the definition of a constructive obligation and inserted into paragraph 15(a) provides *examples* of the actions an entity might take to indicate to other parties that it is willing to accept particular responsibilities. Arguably, the explanatory text of the standard is the appropriate place for these examples, not the definition of a constructive obligation.

Consistency with US GAAP

55. US GAAP literature describes constructive obligations, but does not define them in the same way as IAS 37. For example, Concepts Statement No. 6 *Elements of Financial Statements* admits that liabilities are not restricted to legally enforceable obligations and provides examples of constructive obligations, but it does not *define* a constructive obligation. (Appendix B includes relevant extracts from Concepts Statement No. 6.) Similarly, at a standards level, US GAAP does not define constructive obligations. For example, SFAS 146 explains when and why restructuring costs satisfy the definition of a *liability*, without mentioning constructive obligations. SFAS 143 acknowledges constructive obligations, but limits recognition to those that a court would enforce.

Consistency with the other redeliberations

56. In March 2007, the Board observed that statutes and contracts are simply *mechanisms* that establish an external party's right to call upon the entity to act in a particular way, but the form of the enforcement mechanism is irrelevant in determining whether a present obligation exists. The staff believes that this tentative conclusion supports using the definitions as explanatory text. If the form of the mechanism does not influence whether a present obligation exists and a present obligation is enforceable by legal or equivalent means, there is no need to separately define legal and constructive obligations in IAS 37.

Conclusions

57. The staff considers that clarifying the meaning of 'legally enforceable' would be helpful, for the reasons given in paragraphs 45-49.

Does the Board agree?

58. [Paragraph omitted from the observer notes.]
59. [Paragraph omitted from observer notes.]

60. [Start of paragraph omitted from the observer notes.] Therefore the staff proposes *retaining* the definitions of legal and constructive obligations to the text in any final standard.

Does the Board agree?

E. MORE GUIDANCE ON CONSTRUCTIVE OBLIGATIONS

61. As noted in section B (paragraphs 15-16), a majority of constituents welcomed the new explanatory text proposed in the IAS 37 ED and thought that the level of guidance proposed was appropriate. This section therefore asks whether we need *more* guidance in the text of any final standard. The staff thinks the analysis in this section of the paper is relevant, regardless of the Board's conclusions on sections C and D.
62. Most respondents who requested more guidance asked the Board to specify the type of communication required for another party to 'reasonably rely on' an entity to honour its promise. The staff acknowledges that specifying one or more types of communication would increase consistency in practice. However, the staff does *not* recommend providing more guidance because:
- (a) one size will not fit all. The type of communication required for another party to 'reasonably rely' on an entity to honour its promise will vary according to legal, political and social environments.
 - (b) the ED already provides some examples of the types of communication that may mean another party can rely on an entity to honour its promise. For example, part (a) of the definition of a constructive obligation lists an established pattern of past practice, published policies or a sufficiently specific current statement. Illustrative Examples 3B, 4B, 9 and 11 accompanying the ED illustrate how an entity might apply this guidance.

- (c) more guidance is not required to meet project objectives. The level of guidance proposed in the ED is consistent with the guidance provided in the literature of other national standard setters (see appendix B).
63. Moreover, the staff notes that some respondents opposed providing *any* guidance on constructive obligation, arguing that the current IAS 37 is operational and does not cause diversity in practice. Supporting this argument, the staff notes that the IFRIC has not received requests for further guidance on constructive obligations.

Does the Board agree that any final standard should *not* include more guidance?

APPENDIX A: Other comments on the proposed amendments to constructive obligations in the IAS 37 ED

CL#	Comment letter	Staff response
Misc.	<p>Whilst supporting the proposed amendments, some respondents suggested that the Board delay amending the definition of a constructive obligation and/or providing application guidance until its work on the definition of a liability in the Conceptual Framework is complete, or at least further progressed.</p>	<p>The staff acknowledges the interaction between the topics discussed in this paper and the Board’s work on the definition of a liability in the Conceptual Framework project. However, the staff does not propose delaying the proposals in this paper until work on constructive obligations in the Conceptual Framework project is further progressed. This is because:</p> <ul style="list-style-type: none"> • the proposed amendments achieve greater convergence with SFAS 146 meaning that both Boards will be able to address any future tension with the proposals in its joint Conceptual Framework project from the same position. • on a number of occasions the Board has stated that its work on standards-level projects will not await the conclusion of the Conceptual Framework project. The Board most recently confirmed this statement in the context of the IAS 37 project in January 2007. • a majority of respondents welcomed the application guidance proposed in the ED. Waiting until the Conceptual Framework project is further progressed would delay the availability of this guidance in IFRS literature, especially given that the Board does not envisage publishing the outcome of its work on the definition of a liability until 2008.
Misc.	<p>Whilst supporting the proposed amendments, some respondents noted that some of the illustrative examples of constructive obligations</p>	<p>The staff acknowledges that, in Examples 4B and 9, there is the potential for tension between IAS 37 and IAS 18.¹⁴ At the same time, the staff notes that Board has already sought to address these concerns. Specifically,</p>

¹⁴ In particular, paragraph 13 of IAS 18 which states: “... in certain circumstances it is necessary to apply the recognition criteria to the separately identifiable components of a single transaction in order to reflect the substance of the transaction. For example, when the selling price of a product includes an identifiable amount for subsequent servicing, that amount is deferred and recognised as revenue over the period during which the service is performed. Conversely, the

CL#	Comment letter	Staff response
	<p>accompanying the ED are examples of multiple element arrangements within the scope of IAS 18 <i>Revenue</i>. They therefore asked the Board to clarify the boundary between IAS 37 and IAS 18.</p>	<ul style="list-style-type: none"> • in March 2006 the Board agreed to modify the proposed scope of the IAS 37 ED to clarify that performance obligations measured in accordance with IAS 18 on the basis of the consideration received (ie deferred revenue) would not be in the scope of any final standard (see agenda paper 5A). • the analysis accompanying Illustrative Examples 4B and 9 clearly states that any revenue arising from these transactions should be accounted for in accordance with IAS 18 (Example 4B indirectly through its reference of Example 4A). <p>Also, with regards to Example 9, one could argue that the retail store transfers the risks and rewards of ownership at the point of sale. According to paragraph 17 of IAS 18 this would result in the retail store recognising all of the revenue from the transaction at the point of sale and simultaneously recognising an expense and a liability for the customer's right of return. In other words, the return right is not treated as a revenue-generating liability, rather it is within the scope of IAS 37.</p> <p>Additionally, the staff notes that many of the Illustrative Examples in the ED come from the existing IAS 37. These examples were designed to overcome some of the practices the IASC was trying to eliminate when it issued IAS 37 in 1997 (for example general provisions). Many of these practices no longer exist. Consequently, the staff proposes reviewing all of the Illustrative Examples accompanying the ED at the <i>end</i> of redeliberations. At this stage, therefore, the staff does not propose removing Examples 4B and 9. However, the staff notes the following for future reference:</p> <ul style="list-style-type: none"> • arguably one example of each pertinent point is sufficient. • the IAS 37 ED proposes including more guidance in the text of any final standard,

recognition criteria are applied to two or more transactions together when they are linked in such a way that the commercial effect cannot be understood without reference to the series of transactions as a whole. For example, an entity may sell goods and, at the same time, enter into a separate agreement to repurchase the goods at a later date, thus negating the substantive effect of the transaction; in such a case, the two transactions are dealt with together.”

CL#	Comment letter	Staff response
		<p>reducing the need for numerous illustrative examples.</p> <ul style="list-style-type: none"> • removing Examples 4B and 9 would also reduce the potential for confusion between legal and constructive obligations in some jurisdictions. • Example 9 comes from the existing IAS 37 and is a commonly accepted example of a liability. Arguably, therefore, it adds little value in the IAS 37 ED in terms of illustrating the important tension points the Board is trying to resolve.
3	<p>The discussion of constructive obligation in BC 54 does not address the issue of constructive obligations imposed by competitive and other commercial constraints.</p>	<p>The staff agrees with the observations. See section C.</p>
20	<p>The standard need[s] to state that appropriate disclosures should be made concerning the restructuring plan because such an announcement produces conditional obligations. ... Although the restructuring announcements are not legally bounded, it is extremely rare for a company to recall the originally announced restructuring plan because it would considerably harm the reputation of the firm. ...we believe that a firm should disclose full details of the restructuring plan, once the firm announces it restructuring plan, and that this requirement should be specified in the Standard.</p>	<p>The staff agrees that, in some circumstances, information about anticipated restructuring costs may provide users with decision-useful information even though a specific cost may not satisfy the definition of a liability on the balance sheet date.</p> <p>Following the IAS 37 round-tables the Board agreed to consider disclosure requirements for items that do not satisfy the <i>Framework's</i> definition of a liability. The Board has also agreed to redeliberate the proposed application guidance for restructuring costs (definition, recognition, measurement and disclosure) as part of its redeliberations. Therefore, the staff proposes picking up these comments during those discussions.</p>
23 & 101	<p>The amended definition does not fully converge with US GAAP therefore we question the need for this amendment.</p>	<p>The staff agrees that the proposals in the IAS 37 ED do not achieve full convergence with US GAAP. In particular the staff notes that failing to limit the recognition of constructive obligations to those a court would enforce will not achieve convergence with SFAS 143. However, the staff notes that the Board previously accepted this lack of convergence, for</p>

CL#	Comment letter	Staff response
		the reasons given in section C.
31	Paragraph 15 discusses what to consider in the absence of legal enforceability in terms of satisfying the definition of a liability. Paragraph 16 explains that "... an entity takes into account all available evidence, for example the opinions of experts ..." We are concerned that these experts could be read to include lawyers who argue that no present obligation exists on the balance sheet date (since a legal obligation does not exist).	The staff agrees that the 'experts' referred to in paragraph 16 of the IAS 37 ED might include lawyers. However, the staff believes that the <i>Framework</i> and paragraphs 10 and 14 of the IAS 37 ED clearly state that liabilities are not restricted to legally enforceable obligations. Therefore the staff does not propose amending paragraph 16.
36 & 89	It would be helpful to clarify that the indication required by paragraph 15(a) can be implicit, as well as explicit. For example, participation in a market, unless otherwise indicated, is an implicit indication of an intention to follow the norms of that market.	The staff agrees that an entity's promise to other parties may be implicit or explicit. However, the staff notes that the existence of a market norm, by itself, does not create a present <i>obligation</i> to follow that norm.
61	The FASB should be urged also to define a constructive obligation in the same way in its Concepts Statements and standards, in order to ensure total alignment.	The staff does not agree with this recommendation, for the reasons given in section D of this paper. However, the staff notes that the IASB and the FASB are jointly discussing constructive obligations as part of their work on the Conceptual Framework project.
65	The narrowing of the definition may conflict with liabilities generally, as contained in other standards. (The staff notes that despite this comment, this constituent generally agrees with the proposed amendments to constructive obligations.)	The staff notes that the amendments proposed in the IAS 37 ED were not intended to narrow the <i>definition</i> of a constructive obligation. Rather, the intention was to restrict the <i>recognition</i> of constructive obligations to those an external party can reasonably rely on. Nonetheless, the staff acknowledges that the tentative description of a present obligation (developed in March 2007) may be viewed as narrowing the definition of a liability.

CL#	Comment letter	Staff response
76	<p>While we understand it is drawn from US GAAP, we find the wording in 15(c) slightly odd – particularly in a restructuring the other parties might prefer non-performance but may have not choice.</p>	<p>The staff does not propose amending the wording in paragraph 15(c) of the IAS 37 ED because it is consistent with the wording used in paragraph B19(b)(3) in SFAS 146 and paragraph B26(c) in SFAS 143. Using different words to explain the same sentiment may increase, rather than resolve, confusion.</p>
84	<p>We recommend that the definition of a constructive obligation be amended as follows to reflect that there is a present obligation, rather than a future obligation:</p> <p>Paragraph 10 ...</p> <p>(b) as a result, the entity has created a valid expectation in those parties that they <u>have</u> reasonably rely <u>relied</u> on it to <u>the entity</u> <u>dischargeing</u> those responsibilities.</p>	<p>The staff agrees with this recommendation.</p>
84	<p>Paragraph 14 refers to circumstances existing in a specific jurisdiction. We believe that this paragraph would more appropriately be included in the Basis for Conclusions.</p>	<p>The staff agrees and proposes moving the last sentence of paragraph 14 in the IAS 37 ED to the Basis for Conclusions – ie remove the following sentence: “... 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 effects under other legal systems.”</p>

APPENDIX B: Definitions & descriptions of constructive obligations in the frameworks of national standard setters

Organisation	Definitions and description of a constructive obligation
FASB	<p>Similarly, although most liabilities rest generally on a foundation of legal rights and duties, existence of a legally enforceable claim is not a prerequisite for an obligation to qualify as a liability if for other reasons the entity has the duty or responsibility to pay cash, to transfer other assets, or to provide services to another entity ...</p> <p>... A constructive obligation is created, inferred, or construed from the facts in a particular situation rather than contracted by agreement with another entity or imposed by government. For example, an entity may create a constructive obligation to employees for vacation pay or year-end bonuses by paying them every year even though it is not contractually bound to do so and has not announced a policy to do so. The line between equitable or constructive obligations and obligations that are enforceable in courts of law is not always clear, and the line between equitable or constructive obligations and no obligations may often be even more troublesome because to determine whether an entity is actually bound by an obligation to a third party in the absence of legal enforceability is often extremely difficult. Thus, the concepts of equitable and constructive obligations must be applied with great care. To interpret equitable and constructive obligations too narrowly will tend to exclude significant actual obligations of an entity, while to interpret them too broadly will effectively nullify the definition by including items that lack an essential characteristic of liabilities.</p> <p>(Concepts Statement No. 6 <i>Elements of Financial Statements</i> , paragraphs 35-48)</p>
Australia	<p>A constructive obligation is created, inferred, or construed from the facts in a particular situation rather than contracted by agreement with another entity or imposed by government. An example of a constructive obligation is where an entity has a policy of paying periodic bonuses to employees even though it is not contractually bound to do so, and bonuses for the current reporting period have not yet been paid.</p> <p>(SAC 4 <i>Definition and Recognition of the Elements of Financial Statements</i>, paragraph 48-64)</p>
Canada	<p>Liabilities do not have to be legally enforceable provided that they otherwise meet the definition of liabilities; they can be based on equitable or constructive obligations. ... A constructive obligation is one that can be inferred from the facts in a particular situation as opposed to a contractually based obligation.</p> <p>(S1000 <i>General Accounting Principles</i>, paragraph 34)</p>
New Zealand	<p>The existence of a liability at law is usually a clear indication of the existence of a liability for financial reporting purposes; however, the attributes of a legal liability may be unnecessarily restrictive in defining a liability for financial reporting purposes.</p>

Organisation	Definitions and description of a constructive obligation
	<i>(Statement of Concepts, paragraph 7.13)</i>
United Kingdom	<p>Although many liabilities are based on legal obligations, a legal obligation is not a <i>necessary</i> condition: a liability can exist in the absence of legal obligations if commercial considerations create a constructive obligation.</p> <p>A decision to transfer economic benefits does not, in itself, create a constructive obligation because the transfer can be avoided by changing the decision. On the other hand, a constructive obligation would be created if such a decision was coupled with an event that both created a valid expectation that the entity involved would implement that decision and meant that the entity could not realistically withdraw from it. For example, a constructive obligation may be created by communicating a decision to follow a particular course of action to another party. Such an obligation may also be created by an established pattern of past practice.</p> <p><i>(Statement of Principles, paragraphs 4.26 and 4.27)</i></p>
FASAB	<p>Although all federal liabilities have their foundation in law, some liabilities are construed from the totality of the conditions and facts of a particular situation, rather than from specific legal or regulatory requirements.</p> <p><i>(ED Proposed Statement of Federal Financial Accounting Concepts: Definition and Recognition of Elements of Accrual-Basis Financial Statements, July 2006, paragraphs 35-48)</i></p>
GASB	<p>Sometimes a liability will be created, not because it is legally enforceable, but because it is inferred from the facts and circumstances. In these cases, social, moral, or economic consequences leave the entity little or no discretion to avoid the sacrifice of resources or future resources. Such constructive liabilities generally arise from exchange transactions.</p> <p><i>(ED Proposed Statement of Governmental Accounting Standards Board on concepts related to Elements of Financial Statements, August 06, paragraph 19)</i></p>

APPENDIX C: Potential impact on IAS 19 *Employee Benefits*

- C1. IAS 19 applies the IAS 37 definition of a constructive obligation to two types of employee benefits: (i) informal practices that leave the entity with no discretion to avoid paying employee benefits, and (ii) unvested benefits. The IAS 37 ED therefore proposes a number of consequential amendments to the appropriate paragraphs in IAS 19.
- C2. The staff notes that introducing enforceable (either legally enforceable or enforceable by equivalent means) may be perceived as a significant change for IAS 19. Therefore, further exploring options 1-3 in section C of this paper will involve considering whether additional consequential amendments are required to IAS 19, especially the paragraphs covering employee benefits in category (i) (the table at the end of this appendix identifies those paragraphs).¹⁵ The staff also proposes considering an alternative to making additional consequential amendments to IAS 19. That is, stating that any amendments to constructive obligations in the IAS 37 will *not* change the requirements of IAS 19, even though this may result in some inconsistencies between the two standards.
- C3. The staff offers no comment on the extent and nature of the changes that may be required to IAS 19 as a result of further exploring any of the options in this paper. The staff will include any comments on IAS 19 in its analysis of any of the options the Board asks the staff to explore. Therefore this appendix is for information only.

¹⁵ With respect to unvested benefits (category (ii)), the IAS 37 ED proposes deleting ‘constructive’ from paragraphs 18 and 69 of IAS 19. In other words, the ED says unvested benefits give rise to an *obligation* rather than a constructive obligation. Constructive obligations in category (ii) would therefore be unaffected by the discussions in this paper.

IAS 19 para.	Consequential amendment proposed in the IAS 37 ED
3(c)	<p>The employee benefits to which this Standard applies include those provided:</p> <p>(a) ...</p> <p>(b) ...</p> <p>(c) by those informal practices that give rise to a constructive obligation. Informal practices give rise to a constructive obligation where<u>when</u> the entity has no realistic alternative <u>little, if any, discretion</u> but <u>to avoid paying the employee benefits and the employees can reasonably rely on the entity to pay those benefits</u>. An example of a constructive obligation is where<u>when</u> a change in the entity's informal practices would cause unacceptable damage to its relationship with employees.</p>
17	<p>An entity shall recognise the expected cost of profit-sharing and bonus payments <u>in accordance with</u> under paragraph 10 when, and only when:</p> <p>(a) the entity has a present legal or constructive obligation to make such payments as a result of past events; and</p> <p>(b) a reliable estimate of the obligation can be made.</p> <p>A present obligation exists when, and only when, the entity has no realistic alternative <u>but little, if any, discretion, to avoid</u> make <u>making</u> the payments.</p>
19	<p>An entity may have no legal obligation to pay a bonus. Nevertheless, in some cases, an entity has a <u>long-standing</u> practice of paying bonuses. In such cases, the entity has <u>may have</u> a constructive obligation because <u>if</u> the entity has no realistic alternative <u>little, if any, discretion</u> but <u>to avoid paying the bonus and the employees can reasonably rely on the entity to pay the bonus</u>. The measurement of the constructive obligation reflects the possibility that some employees may leave without receiving a bonus.</p>
52	<p>An entity shall account not only for its legal obligation under the formal terms of a defined benefit plan, but also for any constructive obligation that arises from the entity's informal practices. Informal practices give rise to a constructive obligation where <u>when</u> the entity has no realistic alternative <u>little, if any, discretion</u> but <u>to avoid paying employee benefits and the employees can reasonably rely on the entity to pay those benefits</u>;</p> <p>An example of a constructive obligation is where <u>when</u> a change in the entity's informal practices would cause unacceptable damage to its relationship with employees.</p>