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International
Accounting Standards
Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.

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

INFORMATION FOR OBSERVERS

Board Meeting:	**18 October 2007, London**
Project:	**Liabilities—amendments to IAS 37**
Subject:	**Uncertainty about existence of a present obligation (Agenda Paper 13)**

Purpose of this meeting

1 At recent meetings, the Board has been clarifying the definition of a liability.

2 It has discussed a number of examples with the aim of clarifying whether and why a present obligation does or does not exist. In particular, it has sought to distinguish present obligations from business risks.

3 In May 2007, the Board considered an example that illustrated uncertainty about the existence of a present obligation. The facts of the example were that a vendor had sold a hamburger and there was a 1-in-a-million chance that the hamburger was contaminated. If the hamburger turned out to be contaminated, the vendor would have to pay the customer compensation of £100,000.

4 The Board considered two views of this situation, without concluding which better reflected the nature of the obligation. This paper explores these and other views further and considers their implications for recognition and measurement.

5 The Board will be asked to decide:

a) which of the views it supports; and

b) whether the revised IAS 37 should include guidance or an illustrative example to clarify the Board's conclusions.

Recap of the hamburger example

6 The full facts of the hamburger example discussed in May 2007[1] were:

Example 1 — Sale of hamburger

A vendor sells hamburgers in a jurisdiction where the law stipulates that the vendor must pay compensation of £100,000 to each customer who receives a contaminated hamburger. On 31 December 200X, the last day of the reporting period, the vendor sold one hamburger. Past experience indicates that one in every million hamburgers sold by the vendor is contaminated. No other information is available.

7 The Board decided that on 31 December 200X the vendor would have a present obligation only if it had supplied a contaminated hamburger. However, the Board did not reach any conclusions on how to address the uncertainty in this example. Two possibilities were discussed.

1 Agenda paper 7.

View A

8 The first view explored by staff was that the event that gives rise to the obligation is the **supply of a *contaminated* hamburger**. It is uncertain whether this event has occurred so it is uncertain whether an obligation has arisen.

9 In response to requests from constituents, the Board intends to give more guidance in the revised IAS 37 on how to address situations in which it is uncertain whether an obligation exists. The Board intends to explain that in such situations, management must consider all available evidence to judge whether [it is more likely than not that][2] an obligation exists. The available evidence could include:

a) the entity's past experience;

b) other entities' past experience with similar items;

c) opinions of experts;

d) events occurring after the reporting period; and

e) evidence of the strength of the entity's internal controls.

10 Applying this guidance, the hamburger vendor could reasonably judge that, on the basis of the available evidence, ie past experience, [it is more likely than not that] the hamburger was *not* contaminated and hence that there is not a present obligation.

11 It can be argued that View A is consistent with the Board's previous observations about distinguishing a present obligation from a business risk in that:

a) operating in a jurisdiction subject to a particular law does not in itself give rise to a present obligation. By selling hamburgers in this jurisdiction, the vendor exposes himself to the risk that he will be called upon to pay compensation. But this risk does not amount to a present obligation. The present obligation arises only if the vendor violates the law.

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2 The Board has yet to decide whether to include the phrase 'it is more likely than not that' in the guidance.

b) a present obligation exists only when another party has an ability to call upon the entity to act in a particular way. In the hamburger example, the law provides a mechanism by which another party can enforce his right. However, the customer's right arises only if the law has been violated, ie if the hamburger was in fact contaminated.

View B

12 The alternative view explored at the May meeting was that the event that gives rise to an obligation is **the inception of the contract to sell a hamburger**. The obligation is the unconditional promise that the vendor makes to the customer: to supply a good hamburger *or* pay compensation if the hamburger supplied is contaminated.

13 There is no uncertainty that there is an unconditional promise at the inception of the contract, and hence no uncertainty that a present obligation arose at that time. There is uncertainty as to whether the vendor has fulfilled its obligation. So the vendor should not derecognise its liability fully—it should use the available evidence described in paragraph 9 to measure the remaining obligation.

14 In support of this view, it has been observed that:

a) the price of the hamburger in this jurisdiction will reflect the existence of the law requiring compensation for contaminated hamburgers. The customer is implicitly paying for the vendor's promise. And the vendor would almost certainly have to pay the customer to release him from the promise, or a third party to assume the promise.

b) in its revenue project, the Board has considered other examples in which it not yet certain that the seller has fully discharged its performance obligations to its customer. In these discussions, some Board members have expressed a view that the entity should continue to recognise a liability:

Example 2 – sale of machinery

> An equipment manufacturer has just built a large piece of specialised machinery and installed it at a customer site. Past experience suggests that there is a 20% chance that the machinery will not work to specification and the manufacturer will be called back to refine it.
>
> View A would appear to suggest that, on the basis of available evidence, [it is more likely than not that] the manufacturer does *not* have a remaining performance obligation, and so should not recognise any remaining liability.
>
> However, this view appears inconsistent with views expressed in the context of the revenue project. It has been argued that the manufacturer has not yet fully discharged its performance obligation to deliver and install *working* machinery. Hence, the manufacturer should continue to recognise a liability, reflecting uncertainty about whether further work will be needed in measurement.

View C

15 A third possible view is that the event that gives rise to the obligation to pay compensation is the **supply of a hamburger** to the customer. This view was not explored in the papers for the May meeting, but has been discussed by the staff since.

16 View C appears similar to View B, but it is based on different arguments. The basis of View C is that, once the vendor has supplied a hamburger to a customer, it has to accept all the unavoidable consequences of having done so. These consequences include the obligation to pay compensation if the hamburger was contaminated. It is certain that this obligation exists, even though the outcome is uncertain.

17 In support of this View C, it could be argued that the essential characteristics of a present obligation are present. First, the vendor has no discretion to avoid paying compensation if the hamburger was contaminated. And secondly, that obligation has arisen from a past event, ie the supply of a hamburger to the customer. This fact distinguishes the obligation from a more general business risk, ie that the vendor will be exposed to further compensation claims if it continues to sell hamburgers.

18 Table 1 in the appendix to this paper summarises the differences between Views A-C.

Staff proposal to reject View B

19 Since the Board meeting, the staff have given further thought to the three views discussed above. We now propose that View B misrepresents the nature of the obligation to pay compensation in the hamburger example, and hence that it should be rejected.

20 The basis of View B is that the vendor's obligation arises from its unconditional promise to the customer to supply a good hamburger *or* pay compensation if it supplies a contaminated hamburger. In other words, View B portrays the obligation to pay compensation as part of the vendor's contractual performance obligation to the customer.

21 We now propose that the need to pay compensation should *not* be characterised as a performance obligation:

a) the contractual performance obligation is to supply a good hamburger. The vendor would fulfil that obligation by either supplying a good hamburger first time or, if it supplied a contaminated hamburger, replacing it with another, good one.

b) the possible need to pay compensation is separate from the performance obligation. It arises from the general duty imposed in the vendor's jurisdiction to conduct one's activities without wrongfully harming other persons, eg through negligence. This duty is a general duty owed by all members of society. Only a breach of this duty gives rise to a present obligation that is specific to the vendor.

22 Thus the circumstances of the hamburger example (Example 1) are different from those of the machinery example (Example 2). In the machinery example, the need to make the machinery work to specification *is* part of the seller's performance obligation. So the machinery example is not a valid analogy for the hamburger example.

Question for the Board

23 **Board members will be asked whether they agree that View B misrepresents the nature of the obligation and should be rejected.**

24 Having rejected View B, the remainder of this paper continues to develop only Views A and C. It starts by considering how they would apply to other examples. It then considers their different consequences for recognition and measurement of liabilities.

Extending Views A and C to other examples

25 The hamburger example illustrates a situation in which an entity has an obligation to provide a remedy to persons that it has wrongfully harmed in the course of its activities. There are many examples of similar situations. For example:

Example 3 — hospital death

> A hospital carries out a specific operation to correct a sight defect. During a recent operation, a patient died. Such deaths are rare. If this death was the result of negligence by hospital staff, the hospital will have to pay compensation to the patient's relatives.
>
> The investigation into the cause of death has not yet started. If hospital staff are found to have been negligent, the hospital will have to pay compensation of €1 million.

Example 4 — libel clam

> A newspaper publishes many articles exposing information about people in the public eye. The people exposed sometimes sue for libel. There are currently 10 claims being progressed against the newspaper in respect of articles published before the end of the reporting period.
>
> Having examined the evidence available, the publisher expects 2 of the claims to be successful.

Example 5 — speeding fines

> Drivers employed by a large road haulage company commit an average of 30 speeding offences per month and the company is fined for each one. At the end of the reporting period, the entity still has not been notified of the offences committed in the past month.

View A

26 The staff propose that, applying View A, we would acknowledge that in each of these examples the entity has exposed itself to risks by undertaking its activities. By carrying out operations, the hospital risks having to pay compensation for negligence. By publishing articles, the newspaper risks having to pay libel damages. And by allowing drivers onto roads, the haulage company risks having to pay speeding fines.

27 However, applying View A, it could be argued that no obligation necessarily arises from the activities themselves. A present obligation arises only if during the course of the activities the entity committed a negligent, libellous or criminal act. In each of the above examples, it is uncertain whether the entity committed such an act, and hence whether an obligation exists.

View C

28 The staff propose that, applying View C to these examples, we would conclude that:

a) when hospital has performed an operation, it must accept all of the unavoidable consequences, including an obligation to pay compensation if a patient died and the staff are found to be negligent;

b) when a newspaper has published an article, it must accept all the unavoidable consequences, including an obligation to pay damages if the article was libellous; and

c) when a lorry has undertaken a journey, the haulage company must accept the unavoidable consequences, including an obligation to pay fines if the driver exceeded the speed limit.

29 Thus in each of the above examples, if applying View C, we would conclude that it is certain that an obligation exists — only the outcome is uncertain. Note that the obligation in each case arises only once the activity has taken place. This fact distinguishes the obligation from more general business risks, eg that the hospital will be exposed to negligence claims if it continues to carry out operations.

Expressing Views A and C in more general terms

30 Views A and C could then be expressed in more general terms, ie

a) in many jurisdictions, entities are required by law to provide a remedy to persons who are harmed by their wrongful conduct—eg negligence, nuisance, trespass, defamation.

b) View A is that an obligation to provide a remedy exists only if the entity has committed a wrongful act. If it is uncertain whether the entity has committed a wrongful act, it will be uncertain whether the entity has an obligation.

c) View C is that the obligation arises when the entity has undertaken the activities that could have included committing a wrongful act. The entity is at that point bound to provide a remedy if it has committed a wrongful act.

Applying Views A and C to assets

31 It might also be helpful to consider how Views A and C would be expressed if applied to assets rather than liabilities.

Example 6 — lottery ticket

A man buys a lottery ticket for $1. The prize is $1 million.

Before the draw takes place, it is generally accepted that the man has an asset in the form of a right to participate in the draw. Uncertainty about the outcome of the draw would be reflected in the measurement of the asset.

Suppose that the draw has now taken place, but the results have not yet been published. The man no longer has a right to participate in the draw, but might have the right to the prize of $1 million.

32 View A would be that it is now uncertain whether the man has an asset. View C would be that it is certain that the man has an asset, albeit a different asset from the one he had before the draw. His new asset is the right to collect the prize if his lottery ticket held the winning number.

View A — consequences for recognition and measurement

33 This section considers in more detail the consequences of View A for recognition and measurement. It assumes that all liabilities can be measured reliably, ie that if an item meets the definition of a liability, it should be recognised. For simplicity the effects of risk and the time value of money are ignored.

Consequences of View A for recognition

34 View A is that it is uncertain whether an obligation exists. In such situations, management must consider all available evidence to judge whether [it is more likely than not that] an obligation exists. Only if they judged that [it was more likely than not that] an obligation existed would a liability be recognised. Consider again the hospital example discussed below paragraph 25:

Example 3 Hospital death –recognition – View A

At the reporting date, the investigation into the cause of the patient's death has not yet started, so hospital management have no case-specific evidence. However, suppose that, on the basis of this and other hospitals' past experience, along with evidence of this hospital's general standards of care, management can estimate the probability that hospital staff have been negligent.

If applying a 'more likely than not' threshold:

- if management estimate the probability of negligence to be 40%, they will judge that the hospital staff have not been negligent, and hence that the hospital does not have a present obligation. The hospital will not recognise a liability.
- if management estimate that the probability is 70%, the hospital will recognise a liability.

Without an explicit 'more likely than not' threshold:

Management could reach different judgements. Some might judge that the death is prima facie evidence of negligence and recognise a liability. Others might judge that there is as yet insufficient evidence to support a conclusion that staff have been negligent. Therefore, they might not recognise a liability.

35 The consequences of View A might trouble some people. They might argue that:

a) the absence of a liability when it is possible that one exists is not a faithful depiction of the entity's economic position. The hospital would have to make a payment to a third party or the patient's relatives if it wished to transfer or settle its possible obligation to pay compensation for any past negligence. The financial statements should recognise this burden.

b) wherever the threshold is set, View A produces 'cliff-edge' accounting. For example, applying a 'more likely than not' threshold, the hospital might recognise *no* liability if 45% of past deaths had been attributed to hospital negligence, but a *full* liability if 55% percent of past deaths had been attributed to hospital negligence. Yet, in economic terms, the hospital's position would not be very different.

c) View A appears to have unacceptable consequences for multiple transactions. Suppose that in the hamburger example, the vendor had sold 10 million hamburgers, not just one. On the basis of the available evidence, it would be more likely than not that 10 of these hamburgers were contaminated, and hence that the vendor had a present obligation to make 10 compensation payments. Yet, if the vendor applied View A to each sale individually, it would judge that in each case [it was more likely than not that] the hamburger was not contaminated. Does View A imply that the vendor should not recognise a liability for any of them?

36 In response to these concerns, it could be argued that:

a) the amount that an entity would have to pay to settle or transfer a *possible* (but unlikely) obligation represents an economic burden to the entity, and so would be reflected in a valuation of the entity as a whole. However, it represents the burden of the *risk* of a possible liability, not a measure of the liability itself. The financial statements aim to recognise and measure assets and liabilities, not all of the other factors impacting the value of a business. When considering contingent liabilities, the Board has concluded that possible obligations are not liabilities and should not be recognised.

b) the cliff-edge (or ‘binary’) consequences of View A perhaps feel wrong because uncertainty usually relates to the amount of an asset or liability, not its existence. So we are used to reflecting uncertainty in measurement. However, binary accounting is an accepted consequence of these less common situations when there is uncertainty about existence of an asset or liability, eg if there is uncertainty about whether the entity controls an asset.

c) the concerns about the consequences for multiple transactions (paragraph 35c)) are misplaced. Consider again the hamburger example. The basis of View A is that the obligation does *not* arise from supplying hamburgers. Rather it arises if the vendor supplies a *contaminated hamburger*. If an obligation does not arise from selling hamburgers, there is no reason why the liability recognised after 10 million sales should equal 10 million times the liability recognised after one sale (ie £nil). Sales are relevant only as evidence of the number of times the vendor has been negligent. The sale of 10 million hamburgers would provide evidence that the vendor has sold 10 contaminated hamburgers, and hence has 10 present obligations to pay compensation. So, View A1 *would* lead to the recognition of a liability after 10 million sales, even if it did not lead to the recognition of a liability after one sale.

Consequences of View A for measurement

37 Two different views have emerged regarding the measurement consequences of View A. We have labelled them as View A1 and View A2 and develop them separately below. The essential differences between the two views are summarised in Table 2 of the appendix to this paper.

Measurement — View A1

38 The Exposure Draft proposed that entities should measure liabilities at the amount that they would rationally pay to settle the present obligation or transfer it to a third party at the end of the reporting period.

39 Applying View A, a liability is recognised only if management judge that there *is* a present obligation to pay compensation. Therefore the first view, View A1, is that the liability recognised should also be measured assuming that there *is* a present obligation. In other words, uncertainty about the *existence* of the obligation should not be taken into account in the measurement of the liability. (If there were any uncertainty about the amount of compensation payable, this uncertainty would be reflected in the measurement.)

Example 3 - Hospital death –measurement – View A1

Suppose that hospital management have decided that there is a 70% chance that the death was caused by hospital negligence. This leads them to decide that [it is more likely than not that] the hospital has a present obligation to pay compensation. Therefore, the hospital recognises an obligation to pay compensation.

The obligation is measured at the full €1 million compensation that will be payable if the hospital does indeed have an obligation. In other words, the 30% probability that hospital does not have an obligation is not reflected in the measurement.

<u>Note</u>: If the amount of compensation was not fixed, uncertainty about the *amount payable* would be reflected in the measurement. Suppose the amount payable could be anywhere between €0.8 million and €1 million, the entity would measure the obligation at its expected value, say €0.9 million.

40 The consequences of View A1 for measurement may be troubling to some people:

a) the financial statements will fail to depict and quantify the uncertainty surrounding existence. The possibility that the hospital staff have not been negligent would be taken into consideration by the patients' family or a third party if they were deciding how much to accept to settle or assume the hospital's possible obligation. By not reflecting this uncertainty in the measurement of the obligation, the financial statements do not faithfully depict the hospital's real economic burden.

b) neither will the financial statements reflect changes in estimates from one period to the next. Suppose that one year later, new evidence comes to light and management estimate that it is now 80% likely that the hospital staff have been negligent. The change in the estimates would not be reflected in the measurement of the liability—it would still be measured at €1 million.

41 However, in response to these concerns it could be argued that the present economic situation is that the hospital either *has* or *does not have* an obligation to pay €1 million. If management had perfect information about the present economic situation, there would be no uncertainty. Financial statements should recognise and measure only the present economic situation, or at least management's best assessment of it. They should not overlay the impact of not having perfect information about what the situation is. The risk that the assessment may turn out to be wrong should be communicated via disclosure.

42 Some people might argue that 'more likely than not' (whether explicitly stated or implied) is an unduly conservative threshold if combined with View A1. In other words, if uncertainty about existence is not reflected in measurement, there ought to be a higher degree of certainty that the liability exists before it is recognised. This concern is not a criticism of View A1 per se. If there is support for View A1 among Board members, we could discuss the possibility of a higher threshold when the Board reconsiders the arguments for including 'more likely than not'.

43 It is of note that View A1 can be applied only if uncertainty about existence (which is not reflected in measurement) can be separated from uncertainty about the outflows (which is reflected in measurement). In practice, it might be difficult in some circumstances to separate the different sources of uncertainty.

44 On the other hand, it is also of note that the measurement consequences of View A1 might seem more logical to constituents who have argued that large one-off obligations should be measured at their most likely outcome, not expected value. View A1 does not necessarily result in liabilities being measured at their most likely outcome. But, if management judge that [it is more likely than not that] an obligation exists, the measurement of the liability omits the (less likely) outcome associated with the possibility that there is no obligation. Constituents might be more supportive of measurement at expected value if only probable liabilities were recognised and their measurement excluded the less probable 'not liable' outcomes.

Measurement — View A2

45 Those who agree with View A—that it is uncertain whether an obligation exists—might nevertheless disagree that, if the obligation is recognised, it should be recognised at its full amount. An alternative view, View A2, is that the measurement of the liability should reflect the uncertainties surrounding its existence:

Example 3 - Hospital death – measurement - View A2

Suppose again that hospital management have decided that there is a 70% chance that the death was caused by hospital negligence and hence that [it is more likely than not that] an obligation exists. View A2 would be that the uncertain obligation should be recognised and measured at 70% of a certain obligation, ie (70% x 1) x €1 million = €0.7 million.

46 In support of this view, it could be argued that it more faithfully represents the 'real world' economic position of the entity. It measures that amount that the hospital would have to pay to settle or transfer to a third party the burden of the obligation — this amount would take into account uncertainty about whether the obligation did in fact exist. Further, the financial statements would reflect changes in estimates from one period to the next. If one year later, new evidence came to light and management estimated that the risk of negligence had increased to 80%, the liability would be revised to €0.8 million.

47 Applying View A2, it would be necessary to decide what to recognise if [it were more likely than not that] the entity did *not* have an obligation, eg if there were only a 40% chance that hospital staff had been negligent. It could be argued that, applying View A2, there is no need to make a judgement about whether [it is more likely than not that] an obligation exists before recognising and measuring it—all uncertainty about existence will be addressed in measurement. So, in the hospital example, if management judged that the probability of negligence was only 40%, they would recognise the possible obligation at 40% of €1 million = €0.4 million.

48 However, the staff suggest that this approach would be inconsistent with the basic premise of View A. View A asserts that, in the examples we have been considering, it is uncertain whether or not an obligation exists. To deal with this uncertainty, View A seeks to divide possible obligations into two groups — those that are sufficiently certain to be judged or deemed to be actual obligations, and those that are not. Without a recognition threshold, entities would be recognising items that we would have defined as being no more than possible liabilities. One of the objectives of the revisions to IAS 37 is to avoid recognition of possible liabilities[3]. The staff therefore suggest that View A2 should apply the same recognition threshold as View A1. Without the threshold, the measurement consequences of View A2 would be the same as those for View C (see below) — but they would be less easily rationalised.

Example 3 - Hospital death – recognition and measurement where the obligation is less probable — View A2

Suppose that hospital management have decided that there is only a 40% chance that the death was caused by hospital negligence and hence that [it is more likely than not that] an obligation does not exist. Applying either View A1 or View A2, no liability would be recognised.

[3] Exposure Draft of Proposed Amendments to IAS 37, paragraph BC27.

View C — consequences for recognition and measurement

49 The previous section considered the consequences of View A for recognition and measurement. This section does the same for View C. Like the previous section, it assumes that all liabilities can be measured reliably, ie that if an item meets the definition of a liability, it should be recognised. The differences between the consequences of View C and those of Views A1 and A2 are summarised in Table 2 of the appendix to this paper.

50 As expressed in paragraph 30c), View C is that an obligation arises when the entity has undertaken activities during which it might have inadvertently committed a wrongful act. The entity is at that point bound to provide a remedy if it transpires that it did commit the wrongful act.

51 Applying View C, it is certain that the entity has undertaken the activities, so it is certain that the entity has a present obligation. A liability should be recognised. As it would do when measuring any obligation, the entity would take into account the range of possible outcomes when measuring the amount that it would rationally pay to settle the present obligation or to transfer it to a third party at the end of the reporting period.

52 Some people might be concerned that View C broadens the definition of a liability and would be a burden to implement in practice. It could be portrayed as requiring entities to recognise all possible consequences of past actions, even those that are remote or even as yet unidentified.

53 However, this concern could be addressed by guidance clarifying that:

a) entities should recognise liabilities only if there is evidence supporting the possibility that a past action (eg hospital operation) could have future consequences (eg compensation for negligence). Entities are not required to anticipate consequences for which there is as yet no evidence.

b) if the possibility of any particular consequence is remote, the measure of the liability is likely to become vanishingly small and need not be recognised.

Example 3 Hospital death — recognition and measurement - View C

Every time hospital staff perform an operation, it is possible that they are negligent in some way and that at some future date a claim will be made against the hospital by patients or their families. However, suppose that claims have been made against the hospital in the past only when patients have died or suffered immediate injury during the operation. The hospital need only recognise and measure liabilities for operations if there is evidence that the operations might have involved negligence by staff, ie only if they have resulted in death or immediate injury. In this example, there has been one death and there is a 70% chance that the death was caused by negligence. The hospital would measure its obligation at €1 million x 70% = €0.7 million.

54 In general terms, entities would not need to identify any consequences of past actions other than those that they would also need to identify to apply View A.

55 They may need to recognise and measure liabilities that they would not recognise applying View A1. But they would need to do so only in respect of events that occurred infrequently. For activities that entities carry out frequently, Views A1, A2 and C have the same recognition and measurement consequences. For example, in the hamburger example, if the vendor had sold 10 million burgers, it would recognise and measure a liability of £1 million whether it applied View A1, A2 or C[4]. Similarly, in the hospital example, if there had been 10 deaths, the hospital would recognise a liability of €7 million whether it applied View A1, A2 or C[5].

56 A final point to note is that, despite possible appearances to the contrary, View C does not contradict recent decisions by the Board. In June 2006 the Board tentatively concluded that the start of legal proceedings against an entity was not in itself an event that gave rise to an obligation (ie an obligation to stand ready to perform as the court directed). Consistent with this conclusion, View C would be that, if the entity has an

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4 Views A1 and A2 would recognise 10 obligations of £100,000.
View C would recognise 10 million obligations of £0.10.

5 Views A1 and A2 would recognise 7 obligations of €1 million.
View C would recognise 10 obligations of €0.7 million.

obligation, it arose when the entity committed wrongful acts during past activity. The start of legal proceedings against the entity *may* provide *evidence* that the entity committed such acts and hence that it now needs to recognise an obligation if it has not already done so. But the start of legal proceedings would not in itself be the event that gave rise to the obligation.

Staff conclusions and recommendations

57 [Paragraphs 57-59 of the Board paper explain why the staff recommend View A2. They have been omitted from the observer note.]

60 If the Board concludes in favour of one of the views, the staff will recommend using the preferred view as the basis for additional guidance in the revised IAS 37. This guidance could include an illustrative example, perhaps based on the hospital example in this paper.

Questions for the Board

61 The staff will recommend View A2 for addressing situations in which there is uncertainty about the occurrence of past events. Board members will be asked whether they support that view.

62 If the Board concludes in favour of one of the views, Board members will be asked whether they agree that the preferred view should be used as the basis for additional guidance in the revised IAS 37.

63 If they agree, they will be asked whether they think that the guidance should be based on an illustrative example similar to the hospital example in this paper.

Appendix

Table 1 – summarises 3 different views of the hamburger example

	Views of hamburger example	*Consequences explored further?*
A	The event that gives rise to an obligation is the supply of a *contaminated* hamburger. It is uncertain whether this event has occurred. Therefore **it is uncertain whether an obligation has arisen** at the end of the reporting period.	✓ In Table 2 on next page→
B	The event that gives rise to the performance obligation (to supply a good hamburger *or* pay compensation) is the inception of the contract. **It is certain that an obligation has arisen, but** uncertain whether it has been fulfilled (by providing a good hamburger). Therefore it is **uncertain whether the obligation continues to exist** at the end of the reporting period.	✗ Staff recommend rejecting this view. See paragraphs 19 to 22.
C	The event that gives rise to a present obligation is the supply of hamburgers that *could be* contaminated. Having supplied a hamburger, the entity must accept the unavoidable consequences. The consequences of selling the hamburger include the obligation to pay compensation if it was contaminated. **It is certain that a present obligation exists.** Only the outcome is uncertain.	✓ In Table 2 on next page→

Table 2 – compares the consequences of Views A and C using the hospital example

The available evidence suggests a 70% probability that any death during this routine operation will have been caused by hospital negligence.
If the hospital has been negligent, it will have to pay compensation of €1 million.

	View	Consequences for recognition	Consequences for measurement	In support of this view…
A	An obligation to provide a remedy arises only if the entity commits a wrongful act. If it is uncertain whether the entity has committed a wrongful act, **it is uncertain whether the entity has an obligation.** The obligation would be **to pay compensation.**	A liability is recognised only if management judge [it is more likely than not] that the hospital has an obligation. ▪ If there has been 1 death, management judge [it is more likely than not] that the hospital has 1 obligation. ▪ If there have been 10 deaths, management judge [it is more likely than not] that the hospital has 7 obligations.	<u>A1</u> The measurement assumes that management have judged correctly, ie ▪ If there has been 1 death, 1 x €1 million = €1 million. ▪ If there have been 10 deaths, 7 x €1 million = €7 million	If management had perfect information about the present situation, there would be *no uncertainty*. Financial statements should recognise and measure only the present situation, or at least management's best assessment of it. They should not overlay the impact of not having perfect information about what the present situation is.
			<u>A2</u> Measurement reflects uncertainty about existence using expected values: ▪ If there has been 1 death, (1 x 70%) x €1 m = €0.7 million. ▪ If there have been 10 deaths 7 x €1 million = €7 million	There is uncertainty about whether an obligation exists. It affects the amount that the hospital would have to pay to settle or transfer to a third party the burden of the obligation The financial statements should reflect this uncertainty.
C	An obligation arises when the entity has undertaken activities that could have involved a wrongful act. **It is certain that the entity has an obligation.** The obligation is to accept the unavoidable consequences, **ie to pay compensation if required**. Only the outcome is uncertain.	The activity that gives rise to an obligation is the performance of an operation. However, there is no evidence that the entity might have committed a wrongful act unless a patient has died during the operation. The entity identifies, and hence recognises, an obligation if a patient has died.	The measurement reflects uncertainty about outcome, ie ▪ If there has been 1 death, 1 x (70% x €1 m) = €0.7 million. ▪ If there have been 10 deaths, 10 x one death= €7 million	Management has an unconditional obligation to accept all unavoidable future consequences of its past actions. View C does not widen the range of liabilities to the extent that some might fear — only if there is *evidence* that an activity could have involved a wrongful act would any liability be identified.