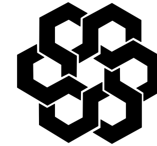

30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
Email: iasb@iasb.org Website: www.iasb.org

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 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:	**Thursday 21 February, London**
Project:	**Liabilities — amendments to IAS 37**
Subject:	**Agenda Paper 6**

PAPER 6 — OVERVIEW OF PAPERS

1. There are two papers for this meeting. They follow up two separate matters that were not fully resolved at previous meetings.

Measurement—settle or transfer

2. **Paper 6A** addresses the proposed measurement requirements. At its December 2007 meeting, the Board decided to consider further whether the proposed requirement—which refers to the amount paid to settle *or* transfer an obligation—gives entities a choice of measurement bases. The staff sought ideas from Board members at small-group meetings in January. Paper 6A follows up the main points arising from these meetings.

Probability recognition criterion

3. **Paper 6B** addresses the proposal to remove the probability recognition criterion from IAS 37. The Board discussed objections to this proposal in June 2006 and January 2007. It did not accept the conceptual objections. But it decided to revisit the practical objections once it had done further work on existence uncertainty and the proposed measurement requirements. This work has now been done and Paper 6A analyses the practical objections again.

PAPER 6A — CLARIFYING THE MEASUREMENT OBJECTIVE

Purpose of paper

1 Paper 6A considers suggestions for clarifying the measurement requirement proposed in the exposure draft of amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*[1]. The main issue addressed is the need for guidance clarifying whether the proposed requirement permits a choice of measurement bases.

Background

2 Paragraph 29 of the exposure draft proposed that:

> **An entity shall measure a non-financial liability at the amount that it would rationally pay to settle the present obligation or to transfer it to a third party on the balance sheet date.**

This wording is based on existing guidance in paragraph 37 of IAS 37. At previous meetings, the Board has confirmed its view that:

[1] Exposure draft of proposed amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and IAS 19 *Employee Benefits*, published June 2005.

a) the proposed new wording clarifies, but does not change, the existing measurement requirement in IAS 37;

b) the requirement aims to measure the price that the entity would pay to be relieved of the obligation on the measurement date. Specifically, 'settle' means 'settle by paying the counterparty on the measurement date' not 'fulfil the obligation using the entity's own resources at a future date'.

3 At its December 2007 meeting, the Board considered feedback that the proposed requirement remains unclear, because it refers to either settling *or* transferring the obligation. Some respondents concluded that the Board was proposing a choice of measurement bases and argued that the choice impaired comparability. Others were uncertain about how to interpret the requirement and asked for more guidance on:

a) whether there were two different measurement bases;

b) if so, whether entities had a free choice about which one to apply; and

c) whether the inclusion of the word 'rationally' implied that the entity should measure the liability at the lower of the two possible measures.

4 The Board decided to consider these questions further with a view to clarifying the requirement in the revised IAS 37. It decided that Board members should first have the opportunity to give ideas to staff in small-group meetings.

5 This paper discusses views expressed by Board members during these small-group meetings. It does not attempt to report the discussions in full. Rather it addresses:

a) views on the main issue, ie whether the requirement permits a choice of measurement basis (paragraphs 7-14); and

b) other matters that the staff think merit further consideration by the Board:

   i) drafting suggestions to clarify the measurement objective (paragraphs 15-20)

   ii) concerns about measurements of settlement amounts (paragraphs 21-30);

   iii) excluding the effects of information asymmetry (paragraphs 31-41)

   iv) whether risk adjustments are necessary for diversifiable risks (paragaphs 42-47).

6 Since the exposure draft was published, the term ‘balance sheet’ has been superseded. In other standards, the phrase ‘on the balance sheet date’ has been replaced with ‘at the end of the reporting period’. The Board will be asked at a future meeting to decide how to update the terminology used in IAS 37. In the meantime, this paper replaces the term ‘balance sheet date’ with ‘measurement date’.

Whether the requirement permits a choice of measurement bases

Board views

7 The paper prepared for the small-group meetings (reproduced in the appendix to Paper 6A but not in the observer note) explored whether the amount that the entity ‘would rationally pay’ to settle or transfer an obligation would be:

a) the maximum amount that the entity would be willing to pay—which would reflect the full value to the entity of being relieved of the burden of satisfying the obligation in future; or

b) the minimum amount that the entity would have to pay, ie the minimum amount that the counterparty would demand to settle the obligation or that a third party would demand to assume the obligation.

8 The way in which these amounts would be determined were explored by reference to two examples — a legal claim and an asset retirement obligation.

9 These examples prompted much discussion of whether, when and how the various amounts would differ, and how they may converge in some circumstances. However, several Board members suggested that *if* there are differences between transfer and settlement amounts, the entity should be seeking to determine the least cost exit route. In other words, the entity should measure the liability at the *lower* of the amount that it would pay to settle the obligation with the counterparty and the amount that it would pay a third party to assume the obligation.

Staff observations

10 The staff observe that this view is consistent with other evidence of the original intention underlying the existing IAS 37 requirement:

a) IAS 37 was developed jointly with the UK accounting standard on the same topic, FRS 12 Provisions, Contingent liabilities and Contingent Assets. The measurement requirement and guidance in paragraphs 36 to 41 of both standards are identical. FRS 12 is accompanied by a basis for conclusions, which explains that the objective of the measurement requirement is to identify and measure the least cost amount required to settle or transfer the obligation:

> 22 For a liability where there is a market, the best estimate of that liability at the balance sheet date would be its market value. The FRS recognises that it will often be impossible or prohibitively expensive to settle or transfer an obligation at the balance sheet date because of the uncertainty relating to provisions. By acknowledging this possibility, the FRS reflects some of the points raised by the respondents to FRED 14. However, a provision should, in principle, be recognised at the amount of the obligation that existed at the balance sheet date—ie the *least cost* amount to settle the present obligation. *Even where it is not possible either to settle or transfer the obligation at the balance sheet date, the process of estimating the amounts at which such hypothetical transactions would take place provides a useful approach to calculating the least cost amount.*[2] (Emphasis added.)

[2] FRS 12 Provisions, *Contingent Liabilities and Contingent Assets*, Appendix VII *The Development of the FRS*.

b) application guidance in the existing IAS 37 (and carried forward into the exposure draft) requires entities to measure onerous contract liabilities at the 'least net cost of exiting from the contract'[3]. The least net cost is defined as the lower of the cost of fulfilling the contract and any compensation or penalties arising from failure to fulfil it. The staff note that the costs of fulfilling a contract underpin estimates of transfer price, while the compensation or penalties arising from failure to fulfil a contract underpin estimates of settlement price.

Staff conclusions and recommendations

11 On the basis of these observations, the staff conclude that IAS 37 does not permit a choice of measurement bases: the inclusion of the word 'rationally' was intended to mean that liabilities should be measured on the basis of the least cost exit amount, ie the lower of the amount that the entity would pay the counterparty to settle the obligation and the amount it would pay a third party to take on the obligation.

12 The staff will recommend that guidance to this effect is added to the standard, to promote consistent application and avoid any impression that the standard permits choice.

Questions for the Board

13 Board members will be asked whether they agree that the word 'rationally' implies that, if there is a difference between transfer and settlement amounts, the entity should measure the liability at the lower amount.

14 If they agree, Board members will be asked whether they also agree that that guidance to this effect should be added to the standard.

[3] Paragraph 68 of the existing IAS 37 and paragraph 58 of the exposure draft of proposed amendments.

Drafting changes to clarify the measurement objective

Board views

15 The objective of the proposed measurement requirement is to measure the amount that the entity would rationally pay on the measurement date to be relieved of its obligation. In other words:

a) the phase 'on the balance sheet date' refers not only to the transfer of the obligation but also to its settlement;

b) 'settle' means 'settle by paying the counterparty on the measurement date' not 'fulfil the obligation using the entity's own resources at a future date'.

16 Some Board members suggested that there was scope for making the objective clearer:

a) the phrase 'on the balance sheet date' should be moved from the end of the sentence (where it might be interpreted as referring only to the transfer, not the settlement); and

b) the requirement should explicitly state that the liability would be settled *with the counterparty*.

Staff observations

17 The staff agree with these suggestions. We note that the existing IAS 37 is clearer than the exposure draft that the phrase 'on the balance sheet date' applies to both transfer and settlement:

> The [amount recognised as a liability] is the amount that an entity would rationally pay to settle the obligation at the balance sheet date or to transfer it to a third party at that time. *Paragraph 37 of existing IAS 37*

18 Clarifying that both settlement amount and transfer amount are current exit amounts may also help address perceptions that the two amounts are very different.

Staff recommendations

19 The staff will recommend the following amendments to the measurement requirement proposed in the exposure draft.

> **An entity shall measure a ~~non-financial~~ liability at the amount that it would rationally pay on the measurement date to settle the present obligation with the counterparty or to transfer it to a third party ~~on the balance sheet date~~.**

Question for the Board

20 Board members will be asked whether they agree with the recommended changes.

Concerns about measurements of settlement amounts

21 Some Board members expressed concerns about measurements of settlement amounts.

22 One concern was that the counterparties to some obligations (eg plaintiffs in lawsuits) do not necessarily base their decisions on informed assessments of the expected cash flows and the time value of money. Counterparties could have a range of motivations and attitudes to settlement. It could be difficult to second-guess the amount the counterparty would demand to settle the obligation, or even to define in principle what the counterparty would *rationally* demand. It is easier to define (and hence estimate) the amount that a third party would rationally demand to assume the obligation—the third party would be putting itself into the same position as the entity and rationally would take into account the same factors as the entity (ie range of possible outcomes, time value of money and risk).

23 Some Board members also indicated that they might view with scepticism estimates of settlement amounts that were significantly less than estimates of transfer amounts. A transfer amount takes into account the expected cash flows for the range of possible outcomes. If the entity could settle the liability with the counterparty for less than this amount, why would it not have done so before now?

Staff observations

24 The staff think that there may be a way to address these concerns if the Board agrees with the first staff recommendation, ie that the liability should be measured at the lower of transfer and settlement amount. The Board could argue that:

a) settlement amount need only be taken into consideration if it is lower than transfer amount; and

b) objective evidence is necessary to support any estimate of settlement amount that is lower than transfer amount.

25 Following this logic, the standard could focus on transfer amount and require entities to take settlement amount into consideration only if there is objective evidence that it is lower than transfer amount. Entities would not routinely have to estimate both transfer and settlement amounts. They would estimate transfer amount and use this amount unless there is objective evidence that the settlement amount would be lower.

26 Guidance could say something like:

> The amount that an entity would rationally pay to settle or transfer an obligation is the least cost amount, that is:
>
> (a) the amount that a third party would demand to assume the obligation; or
>
> (b) the amount that the counterparty would demand to settle the obligation, if there is objective evidence that this amount is lower than (a).

27 Such guidance could make the requirements easier to apply—entities would not have to second-guess the preferences and motivations of the counterparty. They would take into account settlement amount only if there were objective evidence of the amount at which the entity would be willing to settle.

28 There may be a risk that the guidance would be perceived as changing the requirements of IAS 37. However, it may be possible to counter such perceptions by explaining in the basis for conclusions the rationale for requiring objective evidence of settlement amount.

Staff conclusions and recommendations

29 The purpose of this project is to clarify, not change, the existing measurement requirements in IAS 37. The staff conclude that draft guidance on transfer and settlement amounts as sketched in paragraph 24 would not change the requirements. On that basis, the staff will recommend including such guidance in the standard.

Question for the Board

30 Board members will be asked whether they agree.

Excluding effects of information asymmetry

Board views

31 In one of the small-group meetings, Board members observed that liabilities within the scope of IAS 37 are often not transferred to third parties. They suggested that one reason is that the nature of the liabilities is such that the third party would have less information than the entity about the range of possible outcomes and their associated probabilities. A third party would demand a premium for taking on the additional information risk. The entity would be unwilling to pay this premium, because it would not face the same information risk itself.

32 Some Board members suggested that a third party's information risk should not be reflected in the amount that the entity 'would rationally pay' to transfer or settle the liability.

Staff observations

33 The staff observe that this information risk premium could alternatively be viewed as a transaction cost—ie the costs (eg of due diligence) that the third party would incur to obtain the knowledge that the entity holds. For many liabilities within the scope of IAS 37, the costs of obtaining that level of knowledge are prohibitive, so the transaction does not take place.

34 Thus it can be argued that the transfer price should exclude the effects of information asymmetry. The question would then be whether guidance to this effect should be included in IAS 37.

35 On one hand, it could be argued that such guidance would be beyond the scope of this project. The Board has decided to provide more structured guidance on measuring transfer amounts in the final standard than it did in the Exposure Draft. However, it intends to include only high-level guidance, using existing guidance to identify and explain the building blocks of an expected value measurement[4]. Arguably, describing the nature and knowledge of the third party is beyond this remit, especially if the guidance is not exposed for comment.

36 On the other hand, it could be argued that the need to address information asymmetry is already well-established in IFRSs. The IFRS definition of fair value refers to the parties being knowledgeable:

> **Fair value:** the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

37 'Knowledgeable' is defined in the context of IAS 40:

> In this context, 'knowledgeable' means that both the willing buyer and willing seller are reasonably informed about the nature and characteristics of the investment property, its actual and potential uses, and market conditions at the end of the reporting period.

---

[4] January 2007.

38 Although ‘knowledgeable’ might not mean exactly the same as ‘with the same information about the liability as the entity’, it could be an uncontroversial addition to IAS 37 that would clarify to preparers that they should exclude information asymmetry from measures of transfer amounts.

Staff conclusions and recommendations

39 The staff will recommend that the guidance on measuring transfer amounts in IAS 37 should describe the third party as ‘knowledgeable’.

Question for the Board

40 Board members will be asked whether they think that guidance should be added to IAS 37 to address information asymmetry.

41 If they do, they will be asked whether they think that describing the third party as knowledgeable is sufficient.

Whether risk adjustments are necessary for diversifiable risks

Board views

42 Carrying forward the existing requirements of IAS 37, paragraph 35 of the exposure draft proposed that, when measuring a liability, ‘an entity shall include the effects of risks and uncertainties’.

43 During one of the small-group meetings, one Board member suggested that many risks are diversifiable and in a perfect market would not be reflected in the market price of a liability. This Board member suggested that these risks might not even affect the measurement of the liability from the individual entity’s perspective, because the investors in that entity would be able to diversify the risk by holding other investments.

Staff observations

44 Neither the existing IAS 37 nor the exposure draft give much guidance on how to identify and measure the risks that should or should not be taken into account to satisfy the measurement objective. They give no guidance at all on issues such as diversifiable risk.

45 Such guidance could improve the reliability and comparability of liability measurements. But it would take time to develop, could have ramifications for other standards and projects and would need to undergo appropriate due process. So it could be argued that the guidance should not be developed as part of this project.

Staff conclusions and recommendations

46 The staff recommend that the Board does not develop further guidance on risk as part of this project.

Question for the Board

47 Board members will be asked whether they agree.

PAPER 6B — PROBABILITY RECOGNITION CRITERION

Introduction

1. The Exposure Draft of amendments to IAS 37 proposed to remove the probability recognition criterion from IAS 37. Paper 6A considers whether the Board should reinstate the criterion in the final Standard. It includes:

   (a) a recap of discussions to date (paragraphs 3-16):

      (i) the proposal

      (ii) constituent objections

      (iii) the Board's rejection of conceptual objections and decision to consider further only practical objections.

   (b) staff analysis of the practical arguments for retaining the criterion (paragraphs 17-32):

      (i) will removal of the criterion result in many more liabilities being recognised?

      (ii) are liabilities within the scope of IAS 37 different from other liabilities?

      (iii) do the costs of recognising liabilities that do not fulfil the probability measurement criterion exceed the benefits?

   (c) staff conclusions and recommendations (paragraphs 33-38).

Recommendations

2. The paper recommends that the Board:

   (a) confirms its proposal to remove the probability recognition criterion from IAS 37; but

   (b) amends the rationale given in the Basis for Conclusions.

Re-capping discussions to date

The proposal

3. Paragraph 14 of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* specifies that a liability should be recognised if:

   (a) an entity has a present obligation (legal or constructive) as a result of a past event;

   (b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and

   (c) a reliable estimate can be made of the amount of the obligation.

4. For the purpose of IAS 37, 'probable' is defined as meaning 'more likely than not'.

5. The Exposure Draft of amendments to IAS 37 proposed omitting criterion (b)—the 'probability recognition criterion'. Accordingly, all items within the scope of IAS 37 and meeting the definition of a liability would be recognised unless they could not be measured reliably. Uncertainty about the amount and timing of the economic benefits required to settle the obligation would be reflected in the measurement of the liability.

6. The probability recognition criterion derives from paragraph 83 of the *Framework*. Applying the criterion to liabilities, paragraph 91 of the *Framework* states that a liability is recognised only when 'it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation'.

7. The Board justified the proposal to remove the criterion from IAS 37 mainly on the basis that 'in practice the criterion would have no effect in determining whether a liability should be recognised, because in all cases in which an unconditional obligation exists the criterion would be satisfied'[5]. The discussion in paragraphs 36-48 of the Basis for Conclusions focused on stand-ready obligations such as product warranties. It argued that the criterion is always met for such obligations because the outflow of benefits is the provision of a service (of standing ready), not the possible payments to the counterparty. It is certain that the entity will have to provide this service.

8. As a further justification for removing the probability recognition criterion, the Board noted that:

   (a) there is a risk of the criterion being misapplied, because some constituents do not understand that it should be applied to the *un*conditional obligation.

   (b) removal of the probability recognition criterion would make IAS 37 consistent with IAS 39.

Objections to removing the probability recognition criterion

9. The proposal to remove the probability recognition criterion proved to be one of the more controversial proposals in the Exposure Draft. In the comments letters and at round-table meetings, many constituents disagreed with the Board that the probability criterion is always met and hence that it is superfluous. They opposed its removal on the grounds that:

5 Paragraph BC47.

(a) the criterion is necessary to make the recognition requirements in IAS 37 consistent with the *Framework*;

(b) the criterion is a practical means of identifying, and avoiding recognition of, liabilities for which the costs of recognition exceed the benefits. There is a greater need for this practical measure in IAS 37 than in other standards because liabilities within the scope of IAS 37 are more likely to be non-recurring and non-contractual in nature. The costs of measuring such liabilities are higher. If it is not probable that a liability will result in any cash outflows, the costs of recognising and measuring it exceed the benefits.

Subsequent Board discussions

10. In June 2006[6], the Board discussed whether it should reinstate the probability recognition criterion in response to the comment letters.

11. The Board accepted that the probability recognition criterion is not superfluous in all circumstances. For example, an entity may have violated a regulation (so that an obligation exists as a result of past events) but judge that is not probable that the violation will be detected.

12. The Board therefore acknowledged that its proposal to omit the probability recognition criterion could create tension with the *Framework*. However, it did not accept that this tension was sufficient reason to keep the criterion in IAS 37. It took the view that there are other conceptual reasons for removing the criterion from IAS 37:

    (a) the criterion is fundamentally inconsistent with the measurement objective in IAS 37. The measurement objective—the amount that the entity would rationally pay to settle the obligation or to transfer it to a third party at the measurement date—takes into account all possible outcomes, irrespective of whether they more likely than not to occur. Accordingly, if the probability recognition criterion is satisfied, all possible cash flow

---

[6] Agenda paper 3A.

outcomes are reflected in the measurement. However, if the criterion is not satisfied, *none* of the possible outcomes are captured. Similar obligations may be treated very differently. If a liability exists and can be measured reliably, the effect of the probability recognition criterion is to delay the inclusion of decision-useful information in the balance sheet.

(b) the *Framework* does not define 'probable'. The 'more likely than not' threshold exists only in standards. A more likely than not threshold in the *Framework* would result in the flawed conclusion that performance obligations arising from guarantees, warranties and insurance contracts should not be recognised (resulting in a gain being recognised when an entity is paid to take on the obligation).

(c) as a result of conceptual concerns about the criterion, it is being reconsidered in conceptual framework project and is not applied for the purposes of asset or liability recognition in other recent standards. For example, IAS 39 *Financial Instruments: Recognition and Measurement* does not permit a writer of an option to delay the recognition of its obligation to deliver a commodity at a fixed price in the future until it is 'more likely than not' that the holder will exercise the option. Retaining the criterion in IAS 37 would create inconsistencies between IAS 37 and these other standards.

13. Some participants in the round-tables and other consultative meetings agreed that the *Framework* is not immutable and that the Board's proposal has conceptual merit. However, other participants suggested that the Board should not remove the criterion from individual standards until it has updated the *Framework*.

14. The Board discussed the feedback from the round-table meetings at its January 2007 meeting. It rejected the argument that the *Framework* should be amended before the criterion is removed from individual standards, and directed the staff not to spend more time considering the conceptual merits of retaining the criterion.

15. However it acknowledged that there were also practical arguments for retaining the criterion in IAS 37, and that the impact of these requirement would depend on the outcome of it redeliberations of (a) the proposed guidance on existence uncertainty and (b) the proposed measurement requirements.

16. The Board has now completed its work on existence uncertainty and affirmed the proposed measurement requirements. So it is now time to come back to consider the practical arguments for retaining the probability recognition criterion. The rest of this paper analyses these arguments for the Board's consideration.

Staff analysis

Objections to removing the probability recognition criterion on practical grounds

17. Some commentators argued that liabilities within the scope of IAS 37 can be less readily and reliably measurable than other liabilities. The probability recognition criterion should be retained in IAS 37—even if it is not needed in other standards—as a practical means of filtering out liabilities for which the costs of recognition and measurement exceed the benefits. Removal of the criterion would greatly increase the number of liabilities recognised for no great benefit to users.

18. Specific points made in support of this argument were that:

    (a) liabilities within the scope of IAS 37 can be less readily and reliably measurable than liabilities within the scope of other standards.

    Liabilities within the scope of other standards (for example, IASs 17, 18 and 39 and IFRSs 2 and 4) tend to be contractual liabilities. The contracts generally confirm that obligations exist and, by specifying precisely the extent of the obligations, help provide evidence of the future cash flows. Liabilities within the scope of IAS 37 may not stem from a contract, so there may be less certainty about their existence and the eventual outcomes.

A liability within the scope of IAS 37 is more likely than other liabilities to arise from a single, non-recurring transaction (such as a large one-off legal claim), rather than a series of routine transactions. The outcomes of a liability arising from a single, non-recurring transaction can be harder to estimate those arising from recurring transactions because there is no past evidence on which to base decisions.

(b) *there is little additional benefit to be gained from recognising liabilities that are unlikely to result in an outflow of economic benefits*

Some constituents argued that recognising *all* items that satisfy the definition of a liability does not necessarily meet users' needs. Those holding this view argued that the level of uncertainty surrounding the measurement of non-recurring, low probability single obligations requires significant accompanying narrative disclosure. Such disclosure provides the same information as would be provided by a measurement estimate and is more understandable to users. A separate probability recognition criterion in IAS 37 would be a practical means of identifying the liabilities for which there would be least benefit to be gained from recognition.

Analysis of objections

Will removal of the criterion result in many more liabilities being recognised?

19. It is possible to challenge the view that the removal of the probability recognition criterion will result in many more liabilities being recognised.

20. Commentators' perceptions that there will be many more liabilities to recognise may be attributable to insufficient clarity in the Exposure Draft on:

- the boundary between a liability and a business risk. Many respondents appeared to think that the Exposure Draft was proposing recognition of remote items that are business risks, not present obligations.

- the consequences of uncertainty about whether an obligation exists. The probability recognition criterion in IAS 37 needs to be considered only for present obligations whose *existence* has been established. In most cases, a low probability of outflow stems from a low probability that a present obligation exists. For example, a judgement that it is not probable that an entity will have to pay any damages in a negligence case would typically be based on a judgement that it has not been negligent. The judgement would be that no liability exists, so no liability would be recognised even in the absence of a probability recognition criterion.

21. Since the round-table meetings, the Board has spent considerable time clarifying its own views on the boundary between a present obligation and a business risk and the amount of evidence required to support a view that a present obligation exists. The additional guidance in the final standard should help to demonstrate that many potential obligations that are unlikely to result in an outflow of economic benefits do not meet the definition of a liability and so should not be recognised.

22. There are very few items that meet the definition of a liability but are not likely to result in *any* outflow of economic benefits—for most liabilities, *some* outflow of benefits is probable, even if the amount is not expected to be great. Possible exceptions are stand-ready obligations, such as warranties and guarantees. But most of these obligations are already recognised in practice because they are recurring obligations accounted for on a portfolio basis. Therefore the removal of the probability recognition criterion will not have any practical effect for such obligations.

23. It is finally of note that any new liabilities that would be recognised in the absence of a probability recognition criterion are already required by the existing IAS 37 to be disclosed as contingent liabilities (unless they are 'remote') and, when practicable, measured consistently with its measurement requirements. As reported to the Board in June 2006[7], the staff looked at some IFRS accounts from European companies. The sample was not representative. But the contingent

liability disclosures did not suggest that there were many additional liabilities that would be recognised. A contingent liability disclosure in one 2005 annual report was typical:

> In the ordinary course of business, the Group is involved in lawsuits, claims, investigations and proceedings, including product liability, commercial, environment and health and safety matters, etc. There are no such matters pending that the Group expects to be material in relation to the Group's business, financial position or results of operations.

24. In view of these observations, the staff do not think that the removal of the probability recognition criterion would result in the recognition of many more liabilities. Therefore, the criterion should be retained only if it would be inappropriate to recognise the few liabilities that will be affected, ie non-recurring obligations for which management judges that (i) a present obligation exists but (ii) the obligation will probably not result in *any* outflow of economic benefits.

Are liabilities within the scope of IAS 37 different from other liabilities?

25. As explained in paragraph 18(a), unlike liabilities within the scope of other standards, liabilities within the scope of IAS 37 may be non-contractual, non-recurring liabilities. Commentators argued that these attributes may make it more difficult to estimate reliably the range of possible outcomes (the expected cash flows and their timing). Hence there is an argument for retaining the probability recognition criterion in IAS 37, even if it has been dropped from other standards.

26. The staff note that this argument would justify a different treatment for only some of the liabilities within the scope of IAS 37, ie non-contractual, non-recurring liabilities. In other words, if the probability recognition criterion were to be retained in IAS 37, it should be retained by exception for these liabilities only.

---

[7] Paper 3A, paragraph 64.

27. Even then, though, retention of the criterion would not eliminate inconsistencies between IAS 37 and all other standards. The recently-revised IFRS 3 *Business Combinations* does not apply a probability recognition criterion for IAS 37 liabilities recognised as a result of a business combination. Retention of the criterion in IAS 37 would perpetuate differences between the liabilities recognised in a business combination and those recognised at other times.

Will the costs of measuring liabilities be as high as commentators fear?

28. It could be argued that the costs of measuring the liabilities will not be as high are some commentators fear:

 (a) their concerns stem at least in part from their perception that the proposed measurement requirements—which clarify the need to identify all possible outcomes and their associated probabilities—are more onerous than current measurement requirements. The Board has considered these concerns and concluded that it will be able to lessen them by giving more guidance on how an entity would identify the possible outcomes and assign probabilities to them.

 (b) arguably, management should be identifying the possible outcomes and (in rough terms) their associated probabilities whether or not they recognise the liabilities in the accounts. Management needs to know this information to make decisions about how to settle or discharge the obligation.

Are the benefits to users as low as commentators suggest?

29. As detailed in paragraph 18(b), some respondents suggested that users get little benefit from recognition of liabilities for which there is a lower than 50 per cent probability of an outflow of economic benefits. The extensive narrative disclosures required for liabilities within the scope of IAS 37 provide users with the same information as would be encapsulated in the measurement of the liabilities, and are more understandable.

30. In response, it could be noted that:

    (a) the *Framework* does not regard disclosure as an adequate substitute for recognition. Paragraph 82 states that:

        > Items that meet the recognition criteria should be recognised in the balance sheet or income statement. The failure to recognise such items is not rectified by disclosure of the accounting policies used nor by notes or explanatory material.

    (b) narrative disclosures are unlikely to give *all* the information required to estimate the liability, ie the full range of possible outcomes, the probability of each and the estimated timing of each cash flow. One analyst told the staff that users can arrive at widely varying estimates of the impact of an obligation when they rely solely on narrative disclosures. An entity's management has more information than users do, so users benefit from knowing the amount at which the entity's management quantify the liability.

31. The staff suggest that these arguments apply to all material liabilities, not just those for which the probability of an outflow of economic benefits is greater than 50 per cent. Why would a user be interested in the measurement of a liability with a 55 per cent chance of an outflow, but not interested in the measurement of a liability with a 45 per cent chance of an outflow?

32. There may be some cases in which the uncertainties surrounding the outcome of an obligation are so great that users would not derive much benefit from, and may even be misled by, quantification of the liability in the financial statements. Such situations could arise from large unprecedented legal actions. However, the argument for not recognising such liabilities would be that they cannot be reliably measured, *not* that the probability of an outflow of economic benefits is low. The other recognition criterion in IAS 37—ie that liabilities should be recognised only if they can be measured reliably—will address such cases. At a future meeting, the Board will be asked to consider issues specific to lawsuits. The need for any additional guidance on whether and when the 'reliable measurement' criterion would not be met will be considered at that time.

Staff conclusions and recommendations

Removal of probability recognition criterion

33. On the basis of the arguments set out above, the staff conclude that practical considerations do *not* justify the retention of the probability recognition criterion in IAS 37. The staff conclude that:

    (a) removal of the criterion will not lead to the recognition of many more liabilities (paragraphs 19 - 24);

    (b) although some liabilities within the scope of IAS 37 are less easily measured than liabilities within the scope of other standards, the costs of measuring them generally do not outweigh the benefits to users (paragraphs 25-31); and

    (c) the situations in which there may be a case for not recognising liabilities would be addressed by the proposed 'reliable measurement' recognition criterion, the scope of which will be considered at a future meeting (paragraph 32).

34. Accordingly, the staff will recommend that the Board confirm the proposal in the Exposure Draft to remove the probability recognition criterion from IAS 37.

Questions for the Board

35. Board members will be asked whether they agree with the staff recommendation.

36. If the Board does not agree, Board members will be asked whether they think that the probability recognition criterion should be retained for all liabilities within the scope of IAS 37 or only as an exception for non-recurring, non-contractual liabilities.

Rationale for removal of the probability recognition criterion

37. Because the Board's rationale for removing the probability recognition criterion has evolved, the staff will recommend that the Basis for Conclusions be updated. The staff suggest that the rationale should:

    (a) continue to acknowledge the view that the criterion has no effect (which is the rationale used to justify removal of the criterion in IFRS 3[8]), but

    (b) also argue that even if removal of criterion creates some tension with the *Framework*, it could be justified on the grounds that:

        (i) it is fundamentally inconsistent with the measurement objective in IAS 37,

        (ii) as a result of conceptual concerns about the criterion, it is being reconsidered in the conceptual framework project and is not applied in other recent standards, such as IAS 39.

        (iii) it has not been retained in IFRS 3 *Business Combinations*. So its retention in IAS 37 would perpetuate differences between IAS 37 liabilities recognised on the acquisition of a business and those recognised at other times.

    (c) acknowledge commentators' views that the criterion should be retained on practical grounds, but then set out the counter arguments summarised in paragraph 33 above.

Question for the Board

38. If the Board confirms its proposal to remove the probability recognition criterion, Board members will be asked whether they agree that the Basis for Conclusions should be expanded to include all of the arguments listed in paragraph 37.

---

[8] IFRS 3 *Business Combinations*, issued January 2008, paragraphs BC126-BC130.