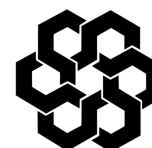

30 Cannon Street, London EC4M 6XH, United Kingdom
Phone: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
Email: iasb@iasb.org Website: http://www.iasb.org

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

IASB Meeting: **20 June 2008, London (Agenda Paper 11A)**

Project: **Conceptual Framework**

Phase B: Elements and Recognition – When Do Statutes, Laws and Regulations Give Rise to a Liability?

INTRODUCTION

1. Some Board members have questioned whether statutes, laws and regulations can give rise to a stand ready obligation—that is, an unconditional obligation that has an associated conditional obligation. To identify when statutes may give rise to such a liability as opposed to a general risk, this paper analyses some common examples of when an unconditional obligation is enforceable by statute[1] and when a risk exists.

2. This paper applies decisions that the Boards have made regarding how to distinguish a liability from a general risk and what constitutes an unconditional obligation that has an associated conditional obligation. The FASB made these decisions in May 2008 as part of the conceptual framework project in the context of the proposed definition of a liability. The IASB made these decisions from March to July of 2007 as part of the work done on

[1] For simplicity, the term "statute" will be used to refer to a statute, a law and a regulation.

liabilities in the IAS 37 project in context of the existing definition of a liability by staff from the IAS 37 and the conceptual framework project.

OBJECTIVE

3. The objective of this paper to demonstrate the situations when statutes can give rise to a liability, including unconditional obligations that have an associated conditional obligation.

PRIOR DECISIONS

4. In the context of the proposed definition of a liability, the Boards have made the following decisions regarding how to distinguish a liability from a general risk.
   (a) A present economic obligation is an essential characteristic of a liability, but not a general risk.
   (b) A present economic obligation exists when:
      (i) an entity is committed to a particular action(s) that is capable of resulting in cash outflows, and
      (ii) there is a mechanism to enable that economic obligation to be enforced against the entity.
   (c) Laws and regulations are examples of mechanisms and are not, by themselves, present obligations.
5. The Boards have also decided the following in regards to stand ready obligations:
   (a) It is helpful to analyse contracts and other binding agreements to identify whether they contain unconditional and conditional obligations.
   (b) An *unconditional obligation* requires performance to occur now or over a period of time, whereas a *conditional obligation* requires performance to occur only if an uncertain future event occurs.
   (c) In situations where a conditional obligation is identified, it can be helpful to assess if there is an accompanying present unconditional obligation that requires the entity to perform.
   (d) Noncontractual scenarios can be analysed to identify unconditional and conditional obligations.

6. Following the Boards' deliberations to date, the working definition of a liability is as follows:

> A *liability* of an entity is a present economic obligation that is enforceable against the entity.
>
> a. *Present* means that the economic obligation exists on the date of the financial statements.
>
> b. An *economic* obligation is something that is capable of resulting in cash outflows or reduced cash inflows, directly or indirectly, alone or together with other economic obligations.
>
> c. Obligations link the entity with what it has to do because obligations are *enforceable* against the entity by legal or equivalent means.

STAFF ANALYSIS

Introduction

7. Statutes can impose requirements upon an entity. Unlike contracts or other binding agreements, statutes are different because an entity does not explicitly agree to perform for another party. Statutes are created by governments and regulators on behalf of citizens and generally apply to broad populations.

8. By operating in a jurisdiction that has statutes, an entity is *subject* to the statutes. That means an entity can be affected if they violate the statute's requirements (or if another event occurs that triggers those requirements). Then, a government or other party could demand that the entity do what the statute requires. The entity might agree to comply with the statute and honour the specified economic obligation[2], if the entity disagrees, it could challenge the obligation then imposed by the statute by seeking a judgement from the courts.

9. Some question why an entity does *not* have a stand ready obligation to comply with a statute and when a statute can give rise to an enforceable obligation. As will be explained further in the next few paragraphs, an entity does not have a stand ready obligation to

[2] For simplicity, the remainder of the paper uses the phrase "obligation" to refer to economic obligation as the financial implications or economic nature of the obligation is known. The issue and focus of the paper is on whether an obligation exists.

comply with a statute by itself because being subject to a statute does not meet the definition of having an unconditonal obligation that has an associated conditional obligation.

10. In prior Board discussions, a stand ready obligation is a term that has been used to describe an unconditional obligation of an entity to perform now or over a period of time and has an associated conditional obligation for an entity to perform if an uncertain future event occurs. In these situations, the unconditional obligation results in the entity having a passive role, such as providing risk protection to a lender in the form of a loan guarantee until a specified event occurs, such as the default of the borrower. If the borrower subsequently defaults, the entity will then have an *active role,* namely that of taking action to repay the lender.

11. In the case of the statute, the entity might appear to have a similar passive role, but the entity is *not* providing a service to another party in the form of risk protection. Thus, no party can force the entity to abide by the statute until the entity *violates,* or another event occurs that triggers, the statute's requirements.

12. For example, a vendor could decide not to sell a potentially contaminated hamburger if a statute required the entity to pay compensation when it *sold* contaminated hamburgers. Thus, before the contaminated hamburger is sold, the statute cannot be enforced against the entity. Until an entity's actions trigger the requirements of the statute, the entity has the ability to decide what actions it takes—for example, to take actions to avoid violating the statute.

13. *When* an event occurs that triggers the requirements of a statute, another party can then demand that the entity perform as specified by the statute. The triggering events and the performance required vary by statute and can depend on the facts and circumstances of the situation. Like contracts and other binding arrangements, statutes can result in:

    (a) unconditional obligations (not associated with any conditional obligations), e.g., a requirement to install an air filter on a smoke stack,

(b) unconditional obligations that have an associated conditional obligation (stand ready obligations), e.g., a statutory warranty (see scenario 2 below), or

(c) conditional obligations, e.g., a requirement to repair or replace a good if it does not work.

14. Another way to test whether a situation results in a risk or an unconditional obligation, is to assess whether the entity would have to pay to be released from the obligation. For example, a customer that has relied on a guarantee provided by an entity would demand compensation if the entity tried to cancel it, whereas a potential customer could not. If the entity stopped providing guarantees with future sales, it could affect the purchasing decisions of potential customers and may result in missed business opportunities for the entity. However, it could not result in obligations to provide compensation to potential customers. This test is applied in the following statutory examples.

Examples

15. The following three scenarios demonstrate when a statute can give rise to the types of obligations described in paragraph 13, and which of those meet the definition of a liability.

Scenario 1: Environmental obligation

> Effective January 1, 2001, a regulation requires businesses to take actions to offset the damage on the environment they cause by emitting carbon dioxide in excess of 100 tons per year. Alternatively, businesses can pay a fine of CU 25 per ton emitted in excess of the allowed limit.
>
> In anticipation of the regulation going into effect, a courier company revises how it operates by consolidating delivery routes and making local deliveries by foot or bike (to reduce carbon emitted) and purchasing forested land (to offset carbon emissions). However, the company still expects to exceed the carbon dioxide limit in 2001.

16. In 2000, the courier company emitted 150 tons of carbon dioxide, but at year-end the company is not subject to the regulation because it is not yet effective.

17. Regardless of the steps taken to reduce its carbon emissions, the courier company projects that it will continue to generate carbon in excess of the limit. At December 31, 2000, the carbon emissions from the company's *future* operations, those post-January 1, 2001, do not presently obligate the company because the regulator could not fine or make the courier company take action now to offset any future damage. The regulator cannot enforce the regulation because that future carbon damage has not yet been occurred. Although, the company projects exceeding carbon limits in the future, it nonetheless has choices. For example, it could stop operating its carbon-emitting vehicles. The pending regulatory requirements and the likelihood that the company will generate carbon emissions in excess of the limit create a risk that the company may have to incur cash outflows to offset the damage or pay a fine *in the future*. However, that risk does *not* create a present obligation.

18. On June 30, 2001, after operating for six months under the new law, the courier company has emitted 100 tons of carbon. The company is subject to the statute but it does *not* yet have an unconditional obligation because its actions have *not* resulted in violating the regulation. The regulator cannot force the entity to do anything—that is to protect the environment or offset any damage done to date—until more than 100 tons of carbon is emitted. Thus, the regulation does *not* result in a stand-ready obligation.

19. By September 30, 2001, the company has generated carbon dioxide in excess of the limit, and therefore has an unconditional obligation because it is now required to take actions to offset the damage it has caused on the environment. For example, the company must either purchase carbon credits or pay the fine, each of which is capable of resulting in cash outflows. If the entity did not take those actions, the government could enforce the regulation against the company and fine it. Thus, this unconditional obligation is a liability of the courier company on the reporting date.

20. *The environmental obligation*[3] *scenario demonstrates that an entity:*

    (a) *does <u>not</u> have a present obligation to comply with a statute that is not yet effective,*

[3] This analysis is consistent with the application of SFAS 143 *Accounting for Asset Retirement Obligations*, FSP FAS 143-1 *Accounting for Electronic Equipment Waste Obligations* and IFRIC Interpretation 6 *Liabilities arising from Participating in a Specific Market—Waste Electrical and Electronic Equipment*.

(b) *does not have a present obligation for expected future actions or intentions because the entity has the ability to avoid or change its future actions,*

(c) *does not have a present obligation to comply with the law by itself. An obligating event must also have occurred, i.e., the company must emit carbon in excess of the limit,*

(d) *does not have an unconditional obligation that has an associated conditional obligation (a stand ready obligation) because the statute does require an entity to provide risk protection, i.e., the courier company is not required to protect the environment from carbon dioxide damage, and*

(e) *can have an unconditional obligation at the reporting date when an entity violates a statute, i.e., company has emitted carbon dioxide in excess of the limit and is required to take action to offset the damage done. This can be a liability.*

Scenario 2: Statutory warranty

> A statute requires that any good sold must be fit for purpose.[4] In the case of light fixtures, the statute requires that a "fit for purpose" lighting fixture must work for at least 1000 hours. If the good is not fit for purpose and does not operate as expected, the seller must repair or replace the good.[5]
>
> An entity manufactures and sells light fixtures in a jurisdiction where the above statute applies. The entity does not explicitly provide or deny providing any warranty on the fixture. A customer purchases one of the entity's light fixtures.

21. Consistent with the prior example, by itself, the fit for purpose statute does *not* give rise to any obligation until the manufacturer sells the light fixture, because the statute applies

---

[4] In common law jurisdictions, fitness for a particular purpose can be an implied warranty. A seller is required to know or have reason to know the *particular purpose* for which some item is being purchased by the buyer. The seller is guaranteeing that the item is fit for that particular purpose, i.e., the good functions as expected for a reasonable period of time. In international sales law, this requirement is found in Article 35(2)(b) of the United Nations Convention on Contracts for the International Sale of Goods. In the United States, the warranty of fitness is in Article 2, Section 315 of the Uniform Commercial Code.

[5] Final condition has been included in this example to provide a specific remedy if the requirement is breached.

only to goods sold to a customer. Thus, while the entity manufactures and offers the light fixtures for sale, these actions of the entity are *not* subject to the statute.

22. A customer would expect that the manufacturer's light fixture, once installed, will provide light for at least 1000 hours. Though the manufacturer did not provide any explicit warranty, upon sale of the good, the risk becomes specific to the manufacturer. The statutory warranty effectively becomes an implicit requirement in the sale agreement between the manufacturer and the customer. The statutory warranty then obligates the manufacturer to protect the customer from a light fixture that does *not* function for at least 1000 hours. If it does not function as expected, then the entity must repair or replace the good. Thus, upon sale, the manufacturer has an unconditional obligation associated with a conditional obligation. The unconditional obligation is to provide this protection service now and for a period of time (at least 1000 hours of service) and therefore is a present obligation. The conditional obligation to repair or replace the good is dependent on the occurrence of an uncertain future event (namely the failure of the light to perform as specified), thus, is *not* a present obligation.

23. Although the government imposed the statute, it would not directly seek to enforce the statutory warranty. Instead, similar to a contractual warranty, the customer is the party that would seek to enforce the statutory warranty against the manufacturer. If the manufacturer did not honour the warranty, the customer would have the support of the courts to enforce the warranty. Also, if the manufacturer wanted to cancel or transfer the warranty, the manufacturer would need to either compensate the customer or pay another party to assume the obligation. [6]

24. The customer installs the light fixture but after two hours of use, the light flickers and stops illuminating. Now, the uncertain future event has occurred and the conditional obligation has become unconditional and a liability. The statutory warranty implicit in the contract with the customer gives the customer the ability or right to demand that the manufacturer repair or replace the light fixture. Until the customer informs the manufacturer that the light fixture does not work, this situation is an example of an

[6] It may be a question of law as to whether a manufacturer could legally cancel a statutory warranty by compensating the customer or by entering into an agreement with another party to transfer it.

obligation that has been incurred but not reported (referred to as an 'IBNR' in insurance terminology) for the manufacturer.

25. Based on the above analysis, a statutory warranty included implicitly in a sale transaction results in the seller of the good having the same contractual obligations as if the warranty is explicitly agreed to in a binding arrangement between two parties.

26. *Compared to the environmental scenario, the statutory warranty example demonstrates that a statute can result in an entity having an implicit unconditional obligation that has an associated conditional obligation or stand ready obligation.*

Scenario 3: Speeding

The law requires drivers to drive vehicles at speeds that do not exceed the limits posted. If a driver drives at speeds higher than the posted limits, the police can ticket a driver. A ticket requires the driver to pay a fine, the financial consequences as stipulated in the law for speeding.[7]

To ensure the quick delivery of packages, an express courier company has indemnified[8] its drivers by agreeing to pay the fines resulting from drivers' speeding tickets incurred while delivering packages.

27. For the drivers, this scenario results risks and obligations that are similar to those in the environmental obligation example. By itself, the law to drive vehicles at the posted rate does *not* impose a present obligation on the driver, because the courts cannot demand payment of fines unless the police have ticketed the drivers for driving at a speed in excess of the posted limit. The law creates a risk for drivers that they could have *future* cash outflows from speeding fines.

28. Even if drivers speed but have not yet been ticketed by the police, the law still does *not* give rise to any obligation, though the drivers' risk of future cash flows to pay speeding

[7] In some jurisdictions, the ticket may also provide the driver the ability to challenge the charge and/or fine in court.

[8] For the purposes of this case, the indemnification is being assumed to be allowed. In practice, it may not be allowed because it encourages the violation of the law.

tickets likely has increased. Once ticketed, the driver has an unconditional obligation to pay the fine.

29. This scenario is different from the others because the courier company has indemnified its drivers and agreed to pay any speeding tickets incurred while they are on the job. The courier company has agreed to: (i) bear the drivers' risk of fines from speeding tickets while they work, and (ii) pay the fines if the drivers are ticketed by the police. Thus, the staff think that the company has an unconditional obligation to its drivers that has an associated conditional obligation to them.

30. The unconditional obligation is present because the courier company has agreed to provide risk protection to the drivers from fines resulting from speeding tickets *when* the drivers drive for the company. Thus, the company is obligated to provide this protection as long as they are employed as drivers.

31. The conditional obligation is to pay the fines if drivers are ticketed. The obligation is conditional because it is dependent on the occurrence of an uncertain future event – that is the drivers being ticketed while delivering their packages. Thus, the company does not have a present obligation or liability to pay fines resulting from speeding tickets until a driver is ticketed.

32. At each reporting date, the courier company must assess whether the conditional obligation has given rise to an unconditional obligation to pay any fines because drivers have been speeding and been ticketed by the police. This unconditional obligation is not associated with any other type of obligation. It is another example of an IBNR obligation. The courier company could implement procedures for drivers to report tickets and use past history to help them to identify and assess the existence of the unconditional obligations to pay fines resulting from speeding tickets. Information received after the reporting date can also subsequently confirm or prove the existence of these obligations.

33. To test whether this situation does result in a liability, consider what would happen if the courier company decided to stop paying the fines resulting from the speeding tickets incurred by its drivers. The drivers would demand compensation to cover the fines they

might incur in order to deliver the packages as required, e.g., a higher wage rate. Thus, the courier company cannot avoid the unconditional obligation to provide the drivers protection from fines resulting from speeding tickets without a cost.

34. *Compared to the prior scenarios, the speeding situation demonstrates that an entity can have an unconditional obligation that has an associated conditional obligation if the entity agrees to bear another's risk of being subject to a statute.*

SUMMARY

35. The following chart summarises the facts of each of the scenarios:

Scenario	Risk/Liability	Who enforces	Who to pay or satisfy
Environmental obligation	- All businesses emitting carbon are subject to regulation. - General risk until violate the regulation by emitting carbon dioxide in excess of limit. - Obligation is to offset damage done or pay the fine.	Regulator	Regulator
Statutory warranty	- All vendors of goods are subject to the statute. - General risk until a light fixture is sold. - Law effectively inserts an implicit contractual obligation into sales agreement between the manufacturer and the customer. - Unconditional obligation to protect the customer from a light fixture that does *not* function as specified for 1000 hours and a conditional obligation to repair or replace the light fixture if it fails.	Customer	Customer
Speeding ticket	Drivers: - All drivers are subject to the law. - General risk until violate the law and are ticketed. - Obligation to pay fine once ticketed. Courier company: - Agreement to bear the drivers' risk of incurring fines creates an unconditional obligation that has an associated conditional obligation to pay fines resulting from speeding tickets.	Government Drivers	Government Government

36. In conclusion, the following list summarizes how an entity:

(a) does *not* have a present obligation to comply with a statute that is not yet effective,

(b) does *not* have a present obligation for expected future actions or intentions because the entity has the ability to avoid or change its future actions,

(c) does *not* have a present obligation to comply with the law by itself. An obligating event must also have occurred,

(d) can have an unconditional obligation at the reporting date when an entity violates a statute,

(e) can have an unconditional obligation that has an associated conditional obligation (a stand ready obligation) when a statute requires an entity to provide risk protection, and

(f) can have an unconditional obligation that has an associated conditional obligation if the entity agrees to bear another's risk of being subject to a statute.

37. **Does the Board agree with the above analysis in paragraph 35 and conclusions in paragraph 36? If not, why not?**