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International Accounting Standards Board

INFORMATION FOR OBSERVERS

IASB Meeting:	**17 June 2008, London (Agenda Paper 11B)**
Project:	**Conceptual Framework**
	Phase B: Elements and Recognition – Dealing with Uncertainty about the Existence of a Liability

INTRODUCTION

1. This paper presents the staff's analysis on how to deal with uncertainty about the *existence* of a liability. This paper divides into the following sections:

   Section I: **Objective –** this section sets out the objective of the discussion and how this paper will consider how to deal with uncertainties about the existence of a liability.

   Section II: **Definitions & descriptions –** this section reviews the proposed working definition of a liability and descriptions of uncertainty, and the role of uncertainty in existing US GAAP and IFRS literature.

   Section III: **How to faithfully represent uncertain items –** this section outlines alternative approaches of how the definition of a liability should be applied to deal with uncertainty and recommends one approach.

Section IV: **Examples** – this section demonstrates the recommended approach by applying it to two common scenarios with uncertainties.

SECTION I: OBJECTIVE

2. It is important to keep in mind that, in the majority of cases, especially in contractual and other binding arrangements, it will be clear whether the definition of a liability has been met. Though uncertainties about the future cash outcome of the liability may make it challenging to measure, they do not negate the existence of a present obligation.

3. In rare cases, uncertainties can make it unclear whether the definition of a liability is met. In these uncertain situations, assessing whether there is a present economic obligation or whether it is enforceable is difficult.

4. *This paper analyses different approaches of how to deal with uncertainties when ascertaining the existence of a liability. The objective of the analysis is to select one approach that will most faithfully represent these uncertainties.*

5. As part of the IASB's *Liabilities* project, planning to amend IAS 37, the IASB has been discussing uncertainty about a present obligation in the context of the existing definition of a liability.[1] This paper builds upon those discussions in the context of the working definition being developed in Phase B of the conceptual framework project.

SECTION II: DEFINITIONS & DESCRIPTIONS

Liability

6. Following the Boards' discussions in December 2007, the working definition of a liability is as follows:

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[1] It is possible that different conclusions might be reached between the IAS 37 and the conceptual framework project – in part because the IAS 37 project is dealing with the existing definition of a liability in the IASB Framework, and in part because the IAS 37 project is a standards-level project rather than a concepts-level project. However, we should be able to justify the reasons for any differences in conclusions reached in each project.

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.

7. Compared to the existing liability definitions in FASB Concepts Statement 6 and in the IASB Framework, the working definition emphasises the need to identify a *present* economic obligation, instead of searching for the transaction or event that created it. Identifying the transaction or event can provide evidence to support a present economic obligation, but it is not essential. Thus, the working definition focuses on the existence of a present economic obligation based on evidence available at a point in time—at the date of the statement of financial position—as to whether there is "something" that is capable of resulting in cash outflows or reduced cash inflows, directly or indirectly, alone or together with other economic obligations.[2]

Uncertainty

8. Uncertainty is a real-world economic phenomenon. Uncertainties result from situations where evidence is lacking or facts are unclear. When ascertaining whether an item meets the definition of a liability, uncertainties can affect whether:

a. an item is an *economic obligation*;

b. it is *the entity's* obligation; or

c. it is a *present* obligation of the entity.

Uncertainty can affect one, some, or all of the requirements of the definition. As a result, we might have insufficient information to know whether a liability exists.

[2] For simplicity, the remainder of the paper uses the phrase "cash outflows" to refer to both cash outflows and reduced cash inflows, directly or indirectly, alone or together with other economic obligations.

9. In practice today, uncertainty about the existence of a liability is dealt with by the use of thresholds in the recognition criteria of the IASB Framework, as well as in US standards and IFRSs.

Thresholds

10. In the IASB Framework, one recognition criterion requires that "an item that meets the definition of an element should be recognised if: (a) it is probable that any future economic benefit associated with the item will flow to or from the entity…" Thus, an obligation that exists should be recognised when the resulting cash outflow to the entity is probable. The IASB Framework does not provide guidance on when it is uncertain that an obligation exists.

11. To deal with situations with uncertainties at the standards level, US GAAP and IFRSs require that for a liability to be *recognised*, it must be probable that the liability has been incurred [FAS 5, paragraph 8a], or a liability is more likely than not to exist [IAS 37, paragraph 15].

SECTION III: HOW TO FAITHFULLY REPRESENT UNCERTAIN ITEMS

Role of the liability definition

12. The concepts in the framework are tools to determine the information that should be included in decision-useful financial reports to assist capital providers in assessing the entity's ability to generate cash flows. As tools, the element definitions are one step in identifying what should be included in financial reports. The definitions identify the relevant items an entity presently has that are capable of affecting its future cash flows.

13. As a screen, the liability definition filters through negative economic phenomena and excludes items that are:

   a. not present at the statement date—they relate to the future;

   b. not of the entity—they belong to another entity,

   c. not economic—they are duties that are not capable of resulting in cash outflows, and

d. not obligations—they are items that cannot be enforced against the entity. The entity can walk away, e.g., budgeted items, or take actions to manage them, e.g. general risks.

After applying the liability definition filter, the remaining items are relevant and are candidates to be communicated to users in the financial reports. Using other concepts in the framework, the information is then assessed as to how to faithfully represent these items. Should they be recognised in the financial statements? Can they be measured? Should information about these relevant items be disclosed? In considering those questions, consideration is given also to how to capture and portray information in an understandable, verifiable, comparable and timely manner in financial reports.

14. When considering liabilities, it will be clear for most items whether they are caught or are excluded. For the narrower range of items, where evidence is lacking or facts are unclear, it will not be clear. These items may or may not meet the definition of a liability. The difficulty is that at the statement date we *don't know*. To exclude these items could result in relevant information not being communicated to users and financial reports not faithfully representing the position of the entity. On the other hand, to include these items might not result in a faithful representation.

15. As uncertainty itself is a real world economic phenomenon, uncertainty does exist. Uncertainty could affect users' decisions, thus, information about uncertainty is relevant information to include in financial reports. The challenge is how to most faithfully represent those liabilities that may or may not exist.

Choices of where to deal with uncertainties

16. At the concepts level, uncertainties could be dealt with:

a. as part of the definition;

b. in the accompanying guidance for applying the definition; or

c. in the criteria for recognition.

17. *As part of the definition*—An additional criterion could be included in the definition to identify when an uncertain item meets the definition. We think that, to do so would detract from the key purpose of the definitions—to deal with generic situations. It would also make the definition cumbersome. The staff do *not* support this choice.

18. *In the accompanying guidance for applying the definition*—Assessing whether an element definition is met involves making a decision—either a liability exists or it does not. Following this approach, additional guidance could describe the steps that should be taken to gather and assess the facts and circumstances of a situation with uncertainties. Examples could be provided to demonstrate how such assessments can be made.

19. This approach would result in the application of a conceptual concept in a practical manner. It would also avoid the use of "likelihood" terms that were used in the existing definition to reflect that few things in life are certain. Not using "likelihood" terms would be an improvement because these terms in the existing definitions have been misunderstood by many. On the other hand, making an assessment based on facts and circumstances results in the implicit application of a threshold. To encourage consistent and comparable application, explicit guidance could be provided in standards.

20. Compared to including a requirement in the definition or the recognition criteria, guidance in the supporting text would be less prominent and therefore could be overlooked by some users.

21. *In the criteria for recognition*—Some think that assessing how to faithfully represent or portray information in financial reports is a recognition matter. It is not a definitional matter because the purpose of the liability definition is to identify the economic obligations of an entity that exist at a statement date. The existence of uncertainty makes the definition difficult to apply. But we cannot know the unknown—all we can do is to decide how to deal with such circumstances when representing items in financial statements—the first step of which is recognition.

22. One of the existing recognition criterion in the FASB and IASB's framework is that an item must meet the definition of an element. Assuming this criterion is retained,

following this approach, uncertain items that may or may not meet the definition would need to be assumed to have met the definition of a liability in order to carry forward these items for consideration in recognition. Then, to strike a balance between developing concepts and providing practical guidance, an additional criterion for recognition at the concepts level could use a threshold to exclude more uncertain items from being recognised. This approach might result in a more consistent application across standards and in practice.

23. On the other hand, this approach might start to blur or confuse the role of a definition from that of recognition. The role of the liability definition is to identify liabilities that exist, whereas recognition is the process of formally incorporating a liability in the financial statements by depicting it in words and numbers. As uncertainty can affect the existence of an obligation as well as the amount and timing of future cash flows of an obligation, this approach may be less effective by considering the different types of uncertainty together in recognition.

24. Whether an uncertain item is a liability that exists or an uncertain liability should be recognised involves making a difficult decision. Leaving the decision to recognition may also be more inefficient as more items would need to be analysed in recognition though they may not be reported in financial statements.

Recommendation

25. Based on the above analysis, the staff think that uncertainty about existence of an asset or a liability should be addressed when ascertaining whether the definition of the element is met. Thus, we recommend that uncertainty be dealt with in how the definitions are to be applied—in the accompanying guidance for applying the definition.

26. **Does the Board agree that uncertainty should be dealt with in the accompanying guidance for applying the definition, rather than in the criteria for recognition or as part of the definition? If not, why not?**

How to apply the definition when uncertainties exist

27. In situations when there is uncertainty about the *existence* of liabilities, the definition of a liability could be applied in various ways. To demonstrate the range of options, the definition could be applied:

    a. Strictly—Assume that a liability does *not* exist in the absence of clear evidence to the contrary.

    b. Judgementally—Judge whether a liability exists based on facts and circumstances at the statement date.

    c. Leniently—Assume that a liability does exist when there is any evidence that the item is capable of resulting in its existence.

28. The judgemental and lenient approaches will result in a greater number of uncertain items being assumed to be liabilities that exist than the strict approach. If the liabilities relating to those uncertain items meet the recognition criteria, if any, uncertainty of their existence could be reflected in how it is measured, and if needed, additional disclosures provided about the item.

29. The staff applied these three approaches to various scenarios to assess which approach would result in the most faithful representation of items when there are uncertainties about the existence of a liability. The analysis was discussed with conceptual framework's joint Board advisors and we noted the following points.

    Strict approach

    - Simplest of approaches because it accounts for all uncertain items as if a liability does not exist.
    - Will likely exclude information from financial reports that may be relevant to users.
    - Approach is conservative. It is *not* neutral.
    - Implicitly requires the application of a threshold as to which items are certain. But, how certain is certain? This concern is what led prior Boards to include the likelihood terms (*probable* and *expected*) in the existing definitions when the existing

frameworks were developed. Importantly, the likelihood terms in the existing frameworks are used to assess the *outcome* of the item, and not its *existence* as is being considered in this paper. In practice, the likelihood terms have been misinterpreted and misapplied. Thus, the working definition of a liability now excludes any likelihood reference.

- Results in deferring the recognition of all cases of which some will be proven to be liabilities that existed. Thus, those cases will result in not recognising those liabilities until some future date—and also will result in recognising losses then.

Judgemental approach

- As proposed, the judgemental approach uses an implicit threshold that is left to users to interpret and apply. To reduce the range of interpretations and result in more comparable application, guidance and consideration of using an explicit threshold, such as "more likely than not", could be considered when developing additional guidance in standards. This approach can result in different entities judging similar items differently.
- Only results in the reporting of incurred but not reported (IBNRs) liabilities when there is enough evidence to judge that a liability exists.
- When there is uncertainty about whose obligation it is, the judgemental approach will more likely result in one entity reporting the existence of the liability if there are enough facts to make a judgement. If facts are unclear, multiple entities could independently judge that they each do or do not have a liability.
- Considering past history can help to make a judgement.
- Assessing a multiple number of similar uncertain items does not affect how one judges the existence of whether each item is a liability that exists.
- Practically, it would exclude fewer items than the strict approach but more than the lenient approach.

Lenient approach

- A conceptual approach that reports any uncertain items capable of resulting in a liability as a liability that exists.
- A less practical, or a more cumbersome, approach because it includes all items that may be liabilities that exist.
- Other concepts could be needed to reduce the number of items reported. For example, users could assess whether the benefits exceed the cost of reporting such items or exclude immaterial liabilities.
- Results in the reporting of incurred but not reported (IBNRs) liabilities when there is a bit of evidence that an obligation is capable of existing, yet insufficient evidence to judge its existence.
- When it is uncertain whose obligation it is, the lenient approach might result in multiple entities reporting a liability for the same obligation.
- Results in recognition of "possible" liabilities and likelihood that some of them will turn out in the future *not* to have been liabilities—and also resulting in gains being recognised then.

Recommendations

30. We think that in situations when there are uncertainties as to whether a liability exists, the liability definition should be applied in a practical manner that results in more relevant information being identified. In these situations, we recommend that a judgemental approach be used to weigh the facts and circumstances at the statement date and judge whether a liability exists[3].

31. We recommend that this approach be applied neutrally when assessing the existence of any element when there are uncertainties.

[3] This approach is consistent with the methodology being followed in the IASB's IAS 37 project on *Liabilities*.

32. As well, we think that, at a standards level, additional guidance should be developed on how those judgments can be made in a comparable manner.

33. **Does the Board agree with the recommendations in paragraphs 30, 31 and 32? If not, why not?**

SECTION IV: EXAMPLES

34. In this section, the staff analyses two common scenarios with uncertainties to demonstrate how the liability definition can be judgementally applied.

35. The examples do not consider any uncertainty about the amount required to settle an obligation. Neither do they consider how the item should be measured, because that does not relate to determining the *existence* of an obligation. The staff acknowledge that, in real life, these other types of uncertainties must also be considered. However, at this stage, the staff wishes to focus on uncertainties that affect the *existence* of a present obligation.

36. For the purpose of this paper, the scenarios and evidence available are limited and deliberately simple. In real life, the staff acknowledges that assessing all of the available evidence relating to the circumstances at the statement date is likely to involve evaluating additional information, such as:

   a. past history of events occurring;

   b. preventive actions taken by an entity to manage the risk; and

   c. subsequent events.

Scenario 1: Hamburger vendor

> A vendor sells hamburgers in a jurisdiction where the law stipulates that the vendor must pay compensation to each customer who buys a contaminated hamburger. On December 31, 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.

37. In this example, the uncertainty relates to whether the obligating event occurred or not (whether a contaminated hamburger was sold).

38. In this jurisdiction, the law imposes a general risk on the population of people who sell hamburgers or vendors. The vendors risk having to pay compensation if they sell contaminated hamburgers to customers. If a vendor violates the law by providing a contaminated hamburger, the customer who received the contaminated hamburger can then demand compensation from that vendor.

39. Some may suggest that vendors have an unconditional obligation to protect customers from the risk of buying a contaminated hamburger and have an associated conditional obligation to pay compensation if the hamburger is contaminated. Staff do not agree, because the law does not require vendors to guarantee or provide risk protection to potential customer(s) that hamburgers for sale are not contaminated. The law does not require vendors to do anything until a contaminated hamburger is sold. If a contaminated hamburger is sold, the vendor then has an unconditional obligation to pay compensation to the customer. This unconditional obligation does not have an associated conditional obligation as payment is due now and is not dependent on the occurrence of any uncertain future event.

40. *No facts or evidence* – At the statement date, the vendor assesses the available evidence. There is no information available about the hamburger sold or the customer's experience after eating the hamburger. Past experience indicates that one in every million hamburgers sold by the vendor is contaminated. The evidence available suggests that the

chance that a contaminated hamburger was sold is low. Therefore, the vendor judges that the one hamburger sold was *not* contaminated and that a liability does *not* exist.

41. *Some facts and evidence* – Compared to the "no facts or evidence" example, the vendor is aware that the refrigerator storing the uncooked hamburgers is broken. The vendor does not know if the refrigerator has been broken for a few hours or days. The evidence suggests that there is more of a chance that a contaminated hamburger was sold, but it is not clear. The vendor could judge that a contaminated hamburger was sold, thus, an obligation to pay compensation to the customer exists. On the other hand, the vendor could judge that there is insufficient evidence to say the hamburger was contaminated, thus, he is *not* obligated to pay compensation to the customer.

42. *Plenty of facts and evidence* – Compared to the "some facts and evidence" example, the vendor is also aware that the customer had her hamburger cooked rare and that bacteria are present on the other hamburgers in the broken refrigerator. As the vendor is aware that his stock of uncooked hamburgers is contaminated and that the customer's hamburger may not have been cooked long enough to kill the bacteria present, the evidence suggests that there is a higher likelihood that a contaminated burger was sold. The vendor judges that a contaminated hamburger was sold, thus, an obligation to pay compensation to the customer, and hence a liability, exists.

43. *Customer's perspective about possible corresponding asset* – Similar to the vendor, the customer does not have an enforceable ability or right to make the vendor pay, until she becomes aware that the hamburger was contaminated by eating or testing it. Once the customer becomes aware that the hamburger was contaminated, then she can use the mechanism to force the vendor to pay compensation and has an asset that exists.

Scenario 2: Lawsuit

On June 30, 200X, an entity has been served papers of a claim for damages by another party. The entity is otherwise unaware of any past wrongdoing.

44. Regardless of whether the claim has merit or not, upon being served, the entity knows it will have to take actions to either defend or settle the claim. It must do something even if

the lawsuit is frivolous. For example, it may consume its employees' time, hire lawyers and experts or pay a settlement. If an entity chose not to act or defend itself, a court could interpret the entity's inaction as guilty and render a judgement in favour of the plaintiff. Each of these scenarios demonstrates that the claim is capable of resulting in cash outflows.

45. At June 30, 200X, the entity does *not* have unconditional obligations for any of the foregoing specific actions because none of employees, lawyers or experts have spent any time on the claim. Thus, the entity does not need to pay them. As well, the entity has not agreed to a settlement with the plaintiff nor has the court rendered a judgement requiring the entity to pay the plaintiff. Thus, at the reporting date, the entity is *not* obligated to pay compensation to the plaintiff.

46. Having been served with papers does raise the question of whether the entity did not perform as required or breached a requirement in the past. The entity would assess the particulars of the claim and determine whether the claim has merit. If the entity decided it was clearly at fault, then the entity would have an obligation to the plaintiff. On the other hand, the entity may challenge the particulars of the claim. For example, the entity may think that it did perform as required or that the event did not qualify as a breach of a requirement. In this scenario, the entity is *uncertain* whether it has an obligation that exists to the plaintiff.

47. Using the judgemental approach, the entity has to assess the available facts and circumstances of the claim at the reporting date. The entity will have to weigh the evidence and judge whether the evidence suggests that the entity is presently obligated. If the entity judges that there is sufficient likelihood that it is obligated, then it has a liability. If it judges that there is insufficient likelihood, then the entity has only a risk that it has a likelihood of cash outflows. The entity should also consider whether the risk should be disclosed.

48. At each reporting date, the entity will need to reassess the available evidence and judge whether it has an obligation.

Conclusion

49. The examples demonstrate that the definition of a liability and judging how to apply the definition in situations with uncertainties, are useful tools because they provide discipline of how to analyse difficult situations. They help to identify who an entity could be obliged to and why it is obliged.