



Project **Liabilities—amendments to IAS 37**

Topic **Stand-ready obligations**

Purpose of meeting

1. This paper contains a refined analysis of the attributes of stand-ready obligations and the circumstances in which such obligations arise. The staff think that this analysis is more complete than the analysis presented to the Board (and reported in *IASB Update*) in October 2007.
2. The purpose of the meeting is to find out whether the Board finds the refined analysis helpful. If so, the staff will make use of the analysis when drafting guidance on to support the liability definition in the revised IAS 37.

Background

3. In the Exposure Draft of proposed amendments to IAS 37, the Board introduced the notion of a ‘stand-ready’ obligation.
4. Respondents expressed concerns about this notion, fearing that it had been defined so broadly that IAS 37 would require entities to recognise liabilities for all sorts of business risks that are not regarded as liabilities at present.

This paper has been prepared by the technical staff of the IASB for the purposes of discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper and do not purport to represent the views of any individual members of the Board or the IASB.

Decisions made by the Board are reported in *IASB Update*.

Official pronouncements of the IASB are published only after the Board has completed its full due process, including appropriate public consultation and formal voting procedures.

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5. The Board decided to give more guidance emphasising the attributes that distinguish stand-ready obligations from business risks. In October 2007, the Board discussed examples in which it was possible, but not yet certain, that an entity had committed an act of wrongdoing. The Board considered whether:
 - (a) the entity *definitely* had a liability—to *stand-ready to pay compensation* if it had committed an act of wrongdoing. This liability should be recognised, with uncertainty about the outcome being reflected in measurement.
 - (b) the entity *possibly* had a liability—if it had committed the act of wrongdoing, it would have a liability *to pay compensation*. Management should consider the available evidence to reach a judgement about whether a liability existed.
6. There was much debate. In the end, the Board concluded that it was more inclined to support the view (b). However, some Board members have since expressed concerns about the conclusion. They are particularly concerned about the perceived wider implications, ie that liabilities for possible wrong-doing never arise until an act of wrong-doing has occurred.
7. FASB and IASB members and staff discussed the examples again at a conference with the American Accounting Association last December. In the light of ideas put forward at that conference, the staff have given more thought to the examples. We now think that, although the conclusions reached by the Board in 2007 were correct, the analysis supporting them was incomplete. And because of the gaps in the analysis, there is a risk that people will apply the conclusions wrongly to other situations.
8. We would therefore like to offer a fuller analysis for consideration by the Board.
9. NB Many people dislike the term ‘stand-ready obligation’. Some think it is redundant and implies a new type of obligation, when in fact stand-ready obligations are just one form of unconditional obligation. The staff will consider ways of avoiding the term when drafting the revised standard. But we have continued to use it in this paper as a convenient and familiar shorthand.

Paper overview

10. This paper develops the alternative analysis. In it the staff:
 - (a) draft a working definition of a stand-ready liability for use in the paper – *paragraphs 12-17*.
 - (b) identify what we now think are important attributes of a stand-ready liability – *paragraphs 18-36*.
 - (c) apply these attributes to the ‘hamburger’ and ‘hospital death’ examples considered by the Board in October 2007 – *paragraphs 37-52*
 - (d) consider whether revised analysis could give rise to problems in practice – *paragraphs 53-54*.

11. The main conclusions in this paper are that:
 - (a) the Board was right to decide in October 2007 that, in the hamburger and hospital death examples, the entities involved did *not* have obligations to stand ready to pay compensation at the end of the reporting period. Rather, it is possible (but not certain) that they had obligations to pay compensation.
 - (b) however, it would be wrong to infer from these examples that no obligations arise until an entity has committed an act of wrong-doing. Stand-ready obligations could have arisen and expired before the end of the reporting period.
 - (c) it would also be wrong to infer from these examples that manufacturers’ warranties do not give rise to stand-ready obligations. The facts of the hamburger and hospital death examples are different from those of some warranties.
 - (d) entities might have more stand-ready obligations than the Board has acknowledged in the past. But the existence of these obligations should not give rise to problems in practice as most will be fleeting or immaterial (because unfavourable outcomes are unlikely).

Working definition of stand-ready obligation

12. The Exposure Draft of proposed amendments to IAS 37 uses the term ‘stand-ready obligation’ without defining it. But it describes the term in ways that allow the staff to draft a definition for use in this paper.
13. The Exposure Draft (like IAS 37) uses the conceptual framework definition of a liability. In particular, it emphasises the need for a ‘present obligation’, and further emphasises that a present obligation must be unconditional, ie its *existence* is not dependent on the occurrence or non occurrence of future events.
14. But it goes on to note that an entity might have a present unconditional obligation whose *outcome* is dependent on the occurrence or non-occurrence future events. In other words, the entity might have a present unconditional obligation to stand ready to incur an outflow of resources if a specified future event occurs or fails to occur. The Exposure Draft refers to this unconditional obligation as a ‘stand-ready obligation’.
15. So we could define a stand ready obligation as:

A present unconditional obligation to stand ready to transfer economic resources if a specified future event occurs or fails to occur.

16. This definition is consistent with the definition of a stand-ready obligation in the insurance discussion paper¹:

An obligation to stand ready to transfer cash, or other economic resources, if a specified event occurs.

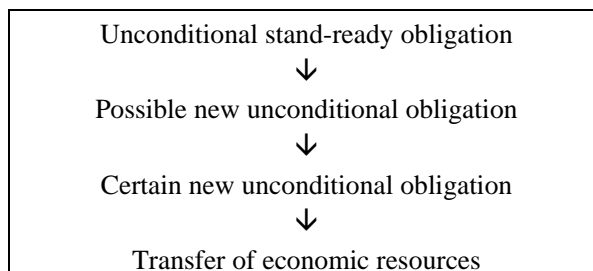
17. But the definition in paragraph 15 also reminds us of attributes that are important for identifying liabilities within the scope of IAS 37, ie that the obligation must be unconditional and the events on which the outcome of the obligation depends lie in the future.

¹ Discussion paper *Preliminary Views on Insurance Contracts*, May 2007, Part 2, Appendix I *Glossary*.

Attributes of stand-ready obligations

Summary of conclusions

18. The staff have identified the attributes of stand-ready obligations that we think help determine whether an entity has such an obligation. We have concluded that:
- (a) a stand-ready obligation arises only if the occurrence or non-occurrence of the future events is outside the control of the entity, ie if the entity cannot prevent the future events from occurring.
 - (b) hence, if the future events could occur only if the entity carries out specific activities, a stand-ready obligation arises only if the entity has already carried out, or has an obligation *to another party* to carry out, those activities.
 - (c) a stand-ready obligation does not lead directly to a transfer of economic resources. In between an unconditional stand-ready obligation and the transfer of economic resources, there must be another unconditional obligation, ie the new obligation that arises if the specified event occurs or fails to occur. Furthermore, if there is a time lapse between the specified event occurring and the event being reported to and validated by the entity, there will also be a period during which it is uncertain whether the new obligation yet exists. Thus, the entity's position changes with time:



19. The rest of this section explains these conclusions in more detail.

The occurrence of the future events must be outside the control of the entity

20. The definition of a stand-ready obligation requires the entity to have an *obligation* to stand ready to transfer economic resources if a specified future event occurs. The Board has previously concluded that an entity has an obligation only if it has a duty or responsibility to act in a particular way², and it owes that duty or responsibility to another party who can rely upon the entity to act in that way³. In other words, it is not enough for the entity to decide, intend, expect or even be compelled economically to stand ready to transfer economic resources. It must have a duty or responsibility *to another party* to do so.
21. This aspect of the definition might be important when considering obligations that are not contractual, such as obligations that might arise from responsibilities to obey laws. Some people fear that the Exposure Draft was proposing that entities have obligations to stand ready to obey laws or to pay the penalties of breaking the law. They ask whether and how the entities should recognise stand-ready liabilities for these obligations.
22. In response, the staff would argue that, although an entity does have a duty to obey a law *if* it conducts the activities to which the law applies, it does not generally have an unconditional obligation to conduct these activities. The duty to comply with the law arises only when the entity accepts a duty to others to carry out the activities. Typically the duty to comply with the law is satisfied (or breached) when the entity carries out the activities. Thereafter, the entity's only remaining obligation would be to pay any penalties for any breach—an obligation that would arise when the breach occurs.

² This was among the conclusions summarised in paragraph 14 Agenda Paper 10A for the July 2007 meeting. The staff had proposed 'is bound' in the paper but, as reported in *Update*, the Board favoured 'has a duty or responsibility', which are the words used in the *Framework*.

³ This was also among the conclusions summarised in paragraph 14 of Agenda Paper 10A for the July 2007 meeting. The paper refers to the other party being able to 'call upon' the entity to act in a particular way. The change to 'rely on' was proposed in later discussions to make the general guidance for obligations consistent with the terminology used to describe constructive obligations.

Example 1 — Public liability

A retailer has a statutory duty to maintain its stores so that they are safe for customers.

The retailer does not have a duty or responsibility to allow customers into a particular store. Therefore the duty of care to the customer arises and is satisfied (or breached) only while a customer is in the store. The retailer has no obligation to maintain its stores in future, or pay compensation for future injuries.

Any obligation to stand ready to pay damages would extend, at most, only for the time it would take to usher outside any customers in its stores at the end of the reporting period.

23. This conclusion can be stated more generally. If an entity can prevent future events from happening, it does not have a present *obligation* to stand ready to do something if these events do happen. An entity has a stand-ready obligation only if it cannot prevent the future events from occurring or failing to occur.

The entity might have continuing stand-ready obligations

24. Sometimes, an entity cannot satisfy all of its obligations as it carries out its activities. It might have ongoing duties in respect of activities that it has already undertaken. These duties could include stand-ready obligations.
25. For example:

Example 2 — Waste disposal

A waste disposal company buries waste. It has a statutory duty to prevent chemicals from the waste leaking into neighbouring farmland. If any contamination of the neighbouring farmland occurs, the company is responsible for decontamination. The company can take measures to ensure that it buries the waste in a manner that minimises the risk of leakage. But after it has buried the waste, it has no means of preventing leakage.

26. Waste not yet buried. On the basis of the arguments in paragraph 22, the staff suggest that the company does not have an obligation to stand ready to decontaminate land if it has *not yet buried* any waste. This is because it does not have an obligation to bury waste at that site in future. Even if it has a contract with the local authority, it could cancel the contract, or bury waste at a different site.
27. Waste already buried. It is possible that waste that the company has already buried will leak in future. The company will incur an obligation to decontaminate the neighbouring land if leakage occurs. The staff think that, if, having already buried the waste, the company has no realistic means of preventing future leakage occurring, it would have a present obligation to stand ready to decontaminate land in future. The amount at which the entity would measure this obligation would depend on the evidence available about the likelihood and extent of future leakage.

The nature of the obligations changes with time

28. An inherent feature of a stand-ready obligation is that it lasts for a period and then expires. The period might be fixed by contract or statute (for example if a manufacturer provides warranty cover for one year), linked to the duration of an activity, or open-ended (for example, the entity's obligation to stand ready to decontaminate land in Example 2 above). But in all cases, the stand-ready obligation expires at the end of the period.
29. If any of specified events occur before the stand-ready obligation expires, a new obligation arises.
30. In some circumstances, the liability stand-ready obligation continues to exist after the specified event occurs. The entity then has two separate obligations:

Example 3 — Household contents insurance

A household insurance policy gives the insurer a stand-ready obligation to pay the costs of replacing goods that are damaged or stolen in the following year.

If the policyholder makes a valid claim during the year, the insurer has a new obligation—to pay that claim. The existing stand-ready obligation might also continue for the remainder of the year.

31. In other circumstances, the specified event extinguishes the stand-ready obligation. The new obligation replaces the stand-ready obligation:

Example 4 — Life insurance

A life insurance policy gives the insurer a stand-ready obligation to pay a lump sum to the estate of any policy holder who dies.

When a policyholder dies, the obligation *to stand ready to pay* the lump sum expires and is replaced by a new obligation *to pay* the lump sum.

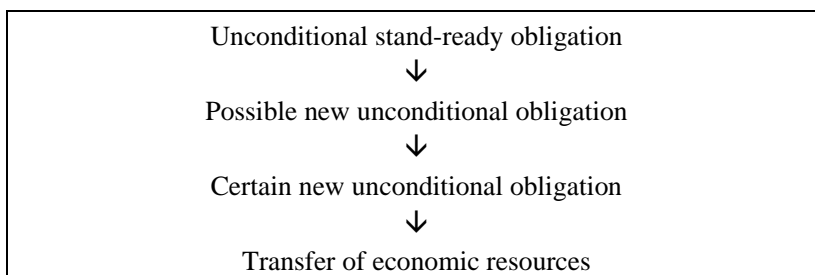
32. In each of these examples, the stand-ready obligation does not lead directly to a transfer of economic resources (ie a payment to a policyholder). In between the unconditional stand-ready obligation and transferring economic resources, the entity has a new unconditional obligation. In other words, the entity's obligation changes over time. Before the event occurs, the entity has a stand-ready obligation. After the event occurs, it has a different unconditional obligation.
33. In practice, entities might not know immediately that the specified event has occurred. It might take some time for the other party to make a claim and for the entity to agree that it is a valid claim.
34. The entity's obligations during this period could be viewed in two different ways. Taking the life insurance example, Example 4 above, it could be argued that:

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- (a) the entity continues to have a stand-ready obligation, ie to stand ready to pay the policyholder if a valid claim is confirmed. The future event for which the entity is standing ready is the validation of the claim: *or*
- (b) it is uncertain what the nature of the entity's obligation is. The event that triggers the obligation to pay a claim is the death, not the insurer's validation of the death. The death is a past event. If the policyholder has died, the entity no longer has a stand-ready obligation. Instead it has a present obligation to pay a claim, a present obligation that will be confirmed by future events. If the policyholder has not died, the entity still has a stand-ready obligation.

35. The staff propose that the nature of the entity's obligations depends on the facts of what has occurred, not what an entity knows or accepts about those facts. On that argument, the staff propose that (b) is a better analysis of the entity's obligations.

36. In which case, the entity would need to account for the following changes as time goes by:



Applying these conclusions to the October 2007 examples

37. This section of the paper applies the conclusions of the previous sections to the ‘hospital death’ and ‘hamburger’ examples considered at the October 2007 Board meeting.

Hospital death

38. Here are the facts of the hospital example:

Example 5 — hospital death

A hospital frequently carries out a specific operation to correct a sight defect. During a recent operation, a patient died. Such deaths are rare. If this death was the result of negligence by hospital staff, the hospital will have to pay compensation to the patient’s relatives.

The investigation into the cause of death has not yet started.

39. The Board considered two analyses of the situation:
- (a) VIEW A: Carrying out an operation exposes the hospital to risks. But it does not in itself give rise to an obligation. An obligation to pay compensation arises only if the hospital staff are negligent. It is uncertain whether the hospital staff have been negligent, and hence whether an obligation exists. The hospital management would have to reach a judgement on the basis of the available evidence.

- (b) VIEW C⁴: when hospital has performed an operation, it must accept all of the unavoidable consequences, including an obligation to pay compensation if a patient dies and hospital staff are found to be negligent. It is certain that this obligation exists: only the amount is uncertain.
40. There was much discussion with a number of Board members finding it difficult to commit to one or other view. But in the end, the Board decided that its views were more closely aligned with View A than with View C. Some people have inferred from this decision that any obligation to pay compensation for an act of wrongdoing arises only when the entity has committed the act.
41. However, the staff would now like to offer the Board a different analysis for consideration, which picks on elements of both View A and View C. Drawing on the attributes of stand-ready obligations in paragraphs 18-36, we'd argue that:
- (a) when the hospital staff started operating on the patient (maybe from the point at which staff administered the general anaesthetic?), the hospital accepted a duty of care for the remainder of the operation at least. This duty of care included an obligation to stand ready to pay compensation if staff negligence harmed the patient during this remaining period.
- (b) this stand-ready obligation applied only to future harm. So as the operation progressed, the hospital was gradually released from the stand-ready obligation. When the patient died, the stand-ready obligation expired—the hospital staff could not harm the patient after this. At the reporting date, the stand-ready obligation no longer exists.

⁴ There was also a View B. The staff included View B in the paper but recommended early on that the Board reject it. The Board unanimously agreed with the staff recommendation. View B was that the obligation to stand ready to pay damages was one of the hospital's contractual obligations to the customer. It was uncertain whether that obligation had been satisfied, so it was uncertain whether the hospital could recognise revenue in respect of that obligation.

- (c) It is possible that during the operation the hospital staff were negligent. The death of the patient is an indication that this might be the case. The staff think that the possibility of negligence means that it is possible (but not certain) that a new obligation has arisen, ie an obligation *to pay compensation*. Applying the arguments in paragraph 35, the entity does not have an obligation *to stand-ready to pay compensation* because the event on which the obligation is conditional is a past event (negligence), not a future event (the confirmation of negligence).
42. So we now think that some aspects of both View A and View C were correct. View A was correct about the entity's position *at the reporting date*. At the reporting date, it is uncertain whether the entity has an obligation. If it does have an obligation, the obligation would be to pay compensation (ie not a stand-ready obligation). That obligation would have arisen if and when hospital staff were negligent. Management need to judge whether the hospital has an obligation based on the available evidence and recognise, or not recognise, a liability accordingly.
43. But we now think View A was wrong about the position of the hospital earlier on the timeline, ie that there was no obligation before negligence occurred. Consistent with View C, we would argue that, when hospital staff started the operation, the entity accepted an obligation for all unavoidable consequences of having started it, including an obligation to stand ready to pay compensation for negligence while the operation is completed. That obligation has expired by the reporting date, but did exist for a short time.
44. So, our conclusion now is that:
- (a) the Board was right to decide that in this example, any obligation at the reporting date would be to pay compensation (not stand-ready to pay compensation). The hospital management would have to judge whether such an obligation existed on the basis of available evidence; but
 - (b) the Board would be wrong to infer from this example that the hospital had no obligation before any negligence occurred, or more generally that no obligations arise until an act of wrongdoing takes place.

Hamburger

45. Here are the facts of the hamburger example considered at the October 2007 meeting:

Example 6 — Sale of hamburger

A vendor sells hamburgers in a jurisdiction where the law stipulates that the vendor must pay compensation of £100,000 to each customer who receives a contaminated hamburger.

On 31 December 200X, the last day of the reporting period, the vendor sold one hamburger.

Past experience indicates that one in every million hamburgers sold by the vendor is contaminated. No other information is available.

46. This is a very artificial example. But, first sticking to the artificial facts and applying the arguments applied to the hospital negligence example, the staff think that:
- (a) the event on which the vendor's obligation is conditional is the sale of a contaminated hamburger
 - (b) at the end of the reporting period, this event would have already occurred—it is not a future event. Therefore any obligation the entity has is to pay compensation, not to *stand-ready* to pay compensation
 - (c) it is uncertain whether the vendor has this obligation. It would have to reach a judgement based on the available evidence. The available evidence suggests that it is highly unlikely that the entity has an obligation.
 - (d) there is no stand-ready obligation of any significance arising before the end of the reporting period. Any stand-ready obligation would exist only between the vendor accepting a duty to sell the hamburger and handing it over to the customer, ie in practice no time at all.

47. So the staff think that the Board's conclusion as reported in *Update* was the correct one:

The Board tentatively concluded that the supply of a hamburger was not sufficient to give rise to an obligation. There must also be evidence that the hamburger was contaminated. If the entity had sold many hamburgers on the last day of the reporting period, previous experience might provide such evidence. However, because only one hamburger had been sold, other evidence would be needed.

48. But, as with the hospital example, we do not think that this example implies that an obligation can arise only when an act of wrongdoing takes place.

What if the facts of the hamburger example were more realistic?

49. When some people recall the hamburger example, they recall a more realistic fact pattern, ie one in which the vendor's obligation is to pay compensation if the customer *becomes sick* because of eating a contaminated hamburger. If this were the fact pattern, the staff would agree that when the vendor sells the hamburger, the event on which the obligation is conditional (the customer becoming sick) is a future event. Therefore from the moment of delivery, the vendor would have an obligation to stand-ready to pay compensation.
50. This obligation expires a day or two after the customer has eaten the burger. If the customer becomes sick in that time, the stand-ready obligation is replaced by an obligation to pay compensation. It might take some time for the vendor to hear about the claim and accept liability. So until that time, the vendor might be uncertain about whether he has a liability. In other words, the vendor's position changes over time. The position at the end of the reporting period will depend on how long it is since the vendor sold the hamburger.
51. It is of note that a minor change in the fact pattern of the hamburger example has affected the conclusions about the nature of the entity's liabilities. Thus the hamburger example illustrates that it is important to specify accurately the nature of the event on which any obligation is conditional.

52. This point might be particularly important when applied to obligations like manufacturers' warranties:
- (a) The *objective* of the warranties might be to compensate the customer for any manufacturing defects that existed when the manufacturer delivered the goods. The manufacturer's obligation might appear to be conditional on a past event (a manufacturing error). This might imply that the manufacturer's remaining obligation after delivery is a *possible obligation to repair or replace* goods.
 - (b) But to make the warranty workable, the manufacturer might in practice warrant to repair or replace *any* of its goods that break down in the year after delivery (subject to some conditions). In which case, it could be argued that the event on which the manufacturer's obligation is actually conditional is the breakdown of goods, ie a future event at the time of delivery. This might imply that the manufacturer's remaining obligation at the time of delivery is a *definite obligation to stand ready* to repair or replace goods.

Would these conclusions be problematic in practice?

53. Based on the above conclusions, the staff think that stand-ready obligations might arise in more circumstances than the Board has previously acknowledged. However, we don't think that this would necessarily give rise to widespread problems in practice:

- (a) many of the stand-ready obligations that people would not recognise as liabilities at present (such as that arising in Example 1—Public liability) are fleeting. There is typically a very short period between an entity being obliged to carry out an act and completing that act, and little or no outstanding obligation thereafter. Few such obligations will still exist at the reporting date.
- (b) even if an entity does in theory have a number of these obligations at the reporting date, the measurement requirements (based on expected value) mean that only major obligations for which there is evidence of a reasonable chance of an outflow of benefits will be material. In the waste disposal example in this paper (Example 2, paragraphs 24-27), the company would need to recognise a liability for future leakage from previously-buried waste only if there was evidence to suggest that leakage was reasonably likely or decontamination costs would be huge.

54. The Board has previously tentatively decided to give more guidance in IAS 37 on identifying stand-ready obligations. It might wish to include reassurance that entities need identify and recognise stand-ready obligations only if there is evidence to indicate that an obligation with a material expected value exists. Such reassurance might be sufficient to avoid perceptions that entities have to speculate about all the things that might go wrong in future and recognise a stand-ready obligation for each.

Questions for the Board

- 1 Paragraphs 41-43 offer a refined analysis of the nature of the liabilities arising in the hospital death example. Do you agree with this analysis?
- 2 Paragraph 52 sets out the staff's views on the implications of the refined hamburger analysis for warranty obligations. Do you agree with the staff views?
- 3 The staff's general conclusions about stand-ready obligations are summarised in paragraph 18. Do you agree with these general conclusions?