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Financial Accounting Series

INVITATION TO COMMENT

**Selected Issues Relating to Assets
and Liabilities with Uncertainties**

Comments are requested by January 3, 2006



Financial Accounting Standards Board
of the Financial Accounting Foundation

Responses from interested parties wishing to comment on the Invitation to Comment must be *received* in writing by January 3, 2006. Interested parties should submit their comments by email to director@fasb.org, File Reference No. 1235-001. Those without email may send their comments to the “Technical Director—File Reference 1235-001” at the address at the bottom of this page. Responses should *not* be sent by fax.

All comments received by the FASB are considered public information. Those comments will be posted to the FASB’s website and will be included in the project’s public record.

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Financial Accounting Standards Board
of the Financial Accounting Foundation
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INTRODUCTION

1. In October 2004, the FASB and IASB embarked on a joint project to develop a converged and improved conceptual framework by building on their existing frameworks. Initial efforts have focused on the objectives of financial reporting and the qualitative characteristics of financial reporting information. Considerable progress has been made in these areas. The purpose of this Invitation to Comment is to solicit input from FASB constituents for use in the next phase of the Boards' conceptual framework project.

2. As part of the project's next phase, the Boards will discuss assets and liabilities, including **the role of probability and uncertainty in defining, recognizing, and measuring assets and liabilities**. The staff's opinion is that the existing frameworks do not adequately address either probability or uncertainty as they relate to assets and liabilities. To some extent, either probability or uncertainty plays some role in defining, recognizing, and measuring assets and liabilities in both frameworks. However, that role is not always clear, and is at times inconsistent within or between frameworks.

3. Issues regarding the treatment of probability and uncertainty exist at the standards level as well. Both the FASB and the IASB have a general standard relating to assets and liabilities with uncertainties. However, there are many differences between the two standards, some of which relate to the use of probability and uncertainty in recognizing and measuring assets and liabilities. The FASB's standard also is inconsistent with its framework, which was developed much later. The IASB's standard does not have this problem as it was issued after its framework.

4. Another issue at the standards level is the change in the treatment of probability and uncertainty that has occurred in more recent standards. The FASB has increasingly favored the use of fair value measurement in its standards. In those cases where fair value measurement has been required for liabilities with uncertainties, the change in measurement attribute has been accompanied by a shift from the use of probability or uncertainty as a recognition criterion to its use in measuring the fair value of the item instead. Treating probability and uncertainty as a measurement problem is not necessarily inconsistent with the FASB framework, but the framework only considers the use of probability and uncertainty in measurement in the context of a present value calculation. It does not assign a measurement role to probability and uncertainty as a matter of principle.

5. IASB standards are undergoing a similar shift. Current proposals by the IASB would not only converge their standards with FASB standards that have changed the role of probability and uncertainty, but also introduce that change to a broader set of situations.

6. The inconsistencies and changes mentioned above present issues that the Boards need to address as they consider probability and uncertainty in the definition, recognition, and measurement of assets and liabilities. Responses to this Invitation to Comment will be used by the FASB in the conceptual framework project to evaluate the relative merits

of the various uses of probability and uncertainty in the Boards' frameworks and standards.

7. The FASB is seeking comments on these matters before they are deliberated by the Boards for two reasons:

- a. To enrich those deliberations
- b. To support an ongoing effort to streamline the standard-setting process and improve the effectiveness of FASB and joint FASB/IASB projects.

This Invitation to Comment does not replace any part of the normal due process procedures for the conceptual framework project. Constituents will have the opportunity to comment on all other due process documents produced in the project.

BACKGROUND

The Frameworks

8. In the frameworks of both Boards, uncertainty is acknowledged as part of the definitions of assets and liabilities. FASB Concepts Statement No. 6, *Elements of Financial Statements*, uses the term *probable* to describe inflows and outflows of future economic benefits in its asset and liability definitions. The IASB *Framework for the Preparation and Presentation of Financial Statements (Framework)* uses the term *expected* in the same manner. However, neither framework imposes a threshold level of probability or expectation of cash inflows or outflows in order for an item to satisfy the definition of an asset or liability. Concepts Statement 6 (footnote 18) explains that *probable* is not used in an accounting or technical sense, but simply to mean not certain or proved, reflecting the nature of the environment in which business and other economic activities occur. Furthermore, Concepts Statement 6 (paragraph 47) classifies the consideration of probability and uncertainty as either a recognition or measurement issue.

9. With respect to recognition of assets and liabilities, the IASB's *Framework* explicitly includes a probability threshold criterion among its recognition criteria. No comparable criterion exists in the FASB framework, although FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, includes additional recognition guidance that is specific to revenues, gains, expenses, and losses. That added guidance, which addresses uncertainty in a limited way through the notion of conservatism, indirectly affects asset and liability recognition.

10. When it comes to the measurement of assets and liabilities, both Boards' frameworks describe multiple measurement attributes or bases, including present (or discounted) value. Probability and uncertainty, therefore, have a measurement role in the frameworks to the extent that present value calculations impound uncertainties.

11. In FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, probability and uncertainty are discussed explicitly. Concepts Statement 7 was issued 25 years after FASB Statement No. 5, *Accounting for*

Contingencies. In Concepts Statement 7 the FASB acknowledged the tension between Statement 5, which is grounded in historical cost and treats probability and uncertainty as a recognition issue, and Concept Statement 7 itself, which focuses on the use of present value techniques to estimate fair value and treats probability and uncertainty as a measurement issue. The Board noted that the use of the term *probable* in Statement 5 refers to the likelihood that an asset has been impaired or a liability has been incurred, while the same term in Concepts Statement 7 refers to the likelihood of the cash flows or other factors that are considered in estimating the fair value of an asset or liability using a present value technique.

The Standards

12. Since 1975, Statement 5 has been the general standard in the United States for accounting for contingent items. Its principal international counterpart, IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, has been in place since 1998. The two standards are by no means identical. However, both Statement 5 and IAS 37 pertain to contingencies and both use the uncertainty of an item that may otherwise meet the definition of an element as a partial determinant of whether that item should be recognized in the financial statements.

13. Statement 5 sets standards for assets and liabilities that are characterized by uncertainty about the amount or timing of future cash flows, though it does so indirectly through gain contingencies and loss contingencies. A contingency involves uncertainty as to whether a gain or loss has occurred in respect of an asset or liability that will be resolved by one or more future confirmatory events. Resolution of the uncertainty may confirm an increase or decrease in the existing asset or liability. Statement 5 requires that the uncertainty embodied in a contingency be dealt with when the contingency arises, not when the events resolve that uncertainty. The uncertainty is not addressed through asset or liability definition (because the asset or liability with uncertainty already exists) or in the measurement of the asset or liability. Instead, uncertainty is addressed in recognition. For a loss contingency, Statement 5 requires recognition of an estimated loss and corresponding asset reduction or liability increase if it is probable (meaning likely) at the reporting date that the future event(s) that confirm the loss will occur. Recognition of an estimated gain related to a gain contingency generally is not permitted even if it is probable that the future event(s) that confirm the gain will occur.

14. IAS 37 also addresses uncertainty through recognition, however, the use of terminology and the scope of IAS 37 differs from Statement 5. IAS 37 uses *provision* to refer to a present liability (either legal or constructive) with uncertain timing or amount of future cash flows. A provision should be recognized if it is probable (that is, more likely than not) that an outflow of resources will be required to settle the liability and a reliable estimate of the amount of the liability can be made. IAS 37 does not address present assets with uncertain cash flows.

15. IAS 37 also uses the terms *contingent liability* and *contingent asset*. Two meanings are assigned to contingent liability: (a) a possible present obligation whose existence can be confirmed only by the occurrence or nonoccurrence of one or more uncertain events

not entirely within the entity's control and (b) a present obligation that is not recognized either because an outflow of resources to settle it is not probable, or its amount cannot be measured reliably. The definition of contingent asset parallels the first meaning given to contingent liability. Under IAS 37, neither contingent liabilities nor contingent assets are recognized.

16. While both Statement 5 and IAS 37 rely on a probability recognition criterion, the term *probable* does not have the same meaning in the two standards. Therefore, their recognition thresholds differ. Statement 5 uses the synonym *likely* for probable, although probable is often interpreted as meaning highly likely (a probability much greater than 50 percent). IAS 37 defines probable as *more likely than not*, interpreted as a probability of at least 51 percent. This inconsistency is increased by the use of the term *probable* in Concepts Statement 6, where probable means simply “not certain.”

17. In contrast to Statement 5, IAS 37 assigns a role to probability and uncertainty in the measurement, as well as the recognition, of liabilities with uncertainties. IAS 37 requires that a provision meeting the recognition criteria be measured at the best estimate of the expenditure required to settle the liability at the balance sheet date. When the provision involves a large population of items, IAS 37 prescribes the use of an expected value approach, which weights possible outcomes by their associated probabilities.

18. In 2001, the year after issuing Concepts Statement 7, the FASB issued Statement No. 143, *Accounting for Asset Retirement Obligations*. Statement 143 requires that present obligations within its scope whose settlement amount and timing may be uncertain be recognized as liabilities in the financial statements at fair value, unless a reasonable estimate of fair value cannot be made. Statement 143 makes explicit that which is implied in Concepts Statement 7, namely that the guidance in Statement 5 (and in FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*) does not apply to a liability for which the measurement objective is fair value. For the obligations within its scope, Statement 143 represents a change in the role of probability and uncertainty from liability recognition to liability measurement.

19. In 2002, the FASB issued Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*. Interpretation 45 clarifies Statement 5's discussion of liabilities that embody uncertainty by refocusing attention from the loss contingency to the liability and refining the language used to discuss that liability. Interpretation 45 identifies a guarantee liability as containing a conditional obligation to perform in settling a liability if the debtor defaults and an unconditional obligation to stand ready to perform the conditional obligation (Interpretation 45 refers to “contingent” and “noncontingent” rather than conditional and unconditional, although the terms are meant to have the same meaning.). Both of the obligations are present obligations. Interpretation 45 requires that a liability within its scope be recognized when the event creating the two obligations occurs, rather than when the settlement of the conditional obligation reaches a certain level of probability. Furthermore, Interpretation 45 generally requires that the guarantee liability be initially measured at its fair value, with uncertainty about the amount and timing of settlement of the conditional obligation reflected in that measurement. Those

requirements represent an extension of the role of probability and uncertainty found in Statement 143.

20. The Boards' frameworks do not discuss the notion of unconditional and conditional obligations within a single liability. Although the notion of an obligation to stand ready to provide services or assets is identified in paragraph 36 of Concepts Statement 6, that notion is not developed. However, nothing in the Boards' frameworks is inconsistent with the idea that a liability can comprise both unconditional and conditional obligations.

21. In March 2005, the FASB issued Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations*, which clarifies that Statement 143 applies to all asset retirement obligations (AROs), including those in which the timing and/or method of settlement are conditional on a future event that may or may not be within the control of the entity (that is, *conditional AROs*). Interpretation 47 emphasizes that a conditional ARO is a present liability which, like the guarantee liability in Interpretation 45, comprises both a conditional obligation to perform asset retirement activities and an unconditional obligation to stand ready to perform the conditional obligation. Statement 143 did not make that point explicit. Because Statement 143 applies to conditional AROs, the liability must be measured initially at fair value, taking into consideration the uncertainty associated with its conditional component. One conceptual difference between the liabilities within the scope of Interpretations 45 and 47 is that guarantees are contractual liabilities while AROs are legal liabilities, a broader category that includes contractual liabilities.

22. In June 2005, the IASB issued an Exposure Draft, *Amendments to IAS 37 Provisions, Contingent Liabilities and Contingent Assets and IAS 19 Employee Benefits*. The Exposure Draft contains, among others, proposed amendments relating to assets and liabilities with uncertainties. If adopted, those proposals would:

- a. Eliminate the term *contingent asset* from IASB standards and refocus analysis of assets with uncertainties on both the unconditional rights and conditional rights that comprise those assets.
- b. Place such dual-right assets within the scope of the IASB's current standard for intangible assets.
- c. Eliminate the term *contingent liability* from IASB standards and refocus analysis of liabilities with uncertainties on the unconditional and conditional obligations that comprise those liabilities.
- d. Refocus the scope of IAS 37 from provisions, contingent assets, and contingent liabilities to nonfinancial liabilities (including those with uncertainties).
- e. Omit the probability recognition criterion for nonfinancial liabilities.
- f. Clarify the measurement rules of IAS 37.

23. The above proposals are based on two notions that also are reflected in Interpretations 45 and 47. These notions are:

- a. The existence of an asset or liability should be established before considering recognition and measurement of the asset or liability.

- b. The effects of probability and uncertainty surrounding an asset or liability should be reflected in the asset or liability's measurement rather than in its recognition.

If the proposals are adopted, IAS 37 and Interpretations 45 and 47 will substantially converge insofar as the liabilities within the scope of the Interpretations are concerned. However, an amended IAS 37 would apply to all nonfinancial liabilities not otherwise addressed in IASB standards, thus extending the two notions to a much broader set of liabilities. In addition, an amended IAS 37 would apply the first notion to assets with uncertainties, a result not found in FASB standards.

24. The IASB will redeliberate the proposed amendments to IAS 37 after it has reviewed the comments it receives from constituents. However, because the Exposure Draft represents the IASB's most current thinking on assets and liabilities with uncertainties, the notions and analysis in that Exposure Draft are expected to be relevant to the Boards' deliberations in the conceptual framework project. Therefore, the FASB is inviting comments from its constituents on the Exposure Draft proposals enumerated in paragraph 22.

INVITATION TO COMMENT

25. This Invitation to Comment addresses certain issues in the IASB Exposure Draft. While some of the questions asked here are identical to those in the IASB Exposure Draft, the numbering of questions in this Invitation to Comment does not correspond to the numbering in the IASB's document. The FASB is particularly seeking input on the questions presented below, although comments on any aspect of the issues underlying the questions are welcome.

26. Responses from interested parties wishing to comment on the Invitation to Comment must be received in writing by January 3, 2006. Interested parties should submit their comments by email to director@fasb.org, File Reference No. 1235-001. Those without email may send their comments to the "Technical Director—File Reference 1235-001" at the following address: Financial Accounting Standards Board, 401 Merritt 7, PO Box 5116, Norwalk, Connecticut 06856-5116. Responses should *not* be sent by fax. Questions regarding this Invitation to Comment may be directed to the staff contact, Kevin H. McBeth, at (203) 956-3440.

27. The IASB's Exposure Draft invites comments on the questions posed in that draft. The FASB does not intend to comment on the IASB's Exposure Draft. Responses to this Invitation to Comment will not be treated as comments to the IASB Exposure Draft. Interested FASB constituents are encouraged to read and respond to all or any part of the IASB Exposure Draft by its comment deadline of October 28, 2005.

ISSUES RELATING TO ASSETS AND LIABILITIES WITH UNCERTAINTIES

Contingent Assets

28. The IASB Exposure Draft proposes to eliminate the term *contingent asset* from IAS 37, as well as from other standards that use that term. IAS 37 currently defines a contingent asset as a possible asset and explains that a contingent asset arises when it is uncertain whether an entity has an asset at the balance sheet date, but it is expected that some future event will confirm whether the entity has an asset.

29. The IASB's basis for eliminating the term *contingent asset* comes in part from the *Framework*, where an asset is defined as a resource that is currently controlled by an entity as a result of a past transaction or event. Because a contingent asset is not a resource that is currently controlled, but only a possible asset, and because whether it becomes a resource controlled by the entity depends on the outcome of a future event, not a past transaction or event, it does not meet the definition of an asset.

30. The IASB also bases its elimination of the contingent asset notion on its current thinking. The IASB has tentatively concluded that in contractual settings, assets may arise only from unconditional or noncontingent rights and not from conditional or contingent rights. The IASB notes that the existence of a conditional or contingent right implies the existence of an underlying unconditional or noncontingent right, and that unconditional right may be difficult to identify. The unconditional right is a present asset; the conditional or contingent right is only a possible future asset and does not meet the definition of an asset. Therefore, the term *contingent asset* is confusing, misleading, and should be eliminated.

31. The IASB uses an insurance contract to illustrate the notion of related unconditional and conditional rights. An entity purchasing an insurance contract has two rights: (a) an unconditional right to insurance coverage and (b) a conditional right to reimbursement if an insured loss occurs in the future. The unconditional right to coverage is a present asset; the conditional right to reimbursement is not a present asset, but only a possible future asset.

32. In the Exposure Draft, the IASB reasons that the conclusions it has reached about unconditional and conditional rights in contractual settings should apply in noncontractual settings as well. It gives three examples to illustrate its reasoning.

33. *Example 1:* An entity has filed a lawsuit against a defendant for damages. The IASB identifies within the lawsuit an unconditional right of the plaintiff to have its claim heard by the courts and a conditional right of the plaintiff to receive compensation from the defendant that is contingent on the decision of the courts. The unconditional right is deemed to be an asset; the conditional right is not.

34. *Example 2:* An entity has applied for an operating license. The IASB classifies the operating license as a conditional right that is contingent on the decision of the awarding

authority and does not qualify as an asset. The IASB also identifies an unconditional right to participate in the process of applying for the license that does qualify as an asset.

35. *Example 3:* An entity is negotiating a contract with a new customer. The IASB views the unexecuted contract as a conditional right that does not qualify as an asset. The IASB also identifies an underlying unconditional right to the economic value of the developing contractual relationship with the customer that does qualify as an asset.

36. In its discussion of contingent assets the IASB focuses on asset definition, not recognition or measurement. Although the notions of unconditional rights and conditional rights parallel those of unconditional and conditional obligations in Interpretations 45 and 47, their use in the IASB Exposure Draft is intended to refine the determination of when an asset exists rather than to imply recognition or measurement treatment. If the proposals about assets are adopted, the term *contingent asset* will be eliminated from IAS 37 and language will be added to IAS 38, *Intangible Assets*, expanding the realm of intangible assets to include assets comprising both unconditional and conditional rights. Current recognition and measurement rules in IAS 38 will apply to those assets.

37. For a complete exposition of the IASB's reasoning with respect to eliminating the notion of a contingent asset, see paragraphs BC7–BC18 of the IASB Exposure Draft (reproduced in the attached appendix).

Question 1: Do you agree with eliminating the notion of contingent asset? If not, why not?

Question 2: Do you agree with the IASB's analysis of unconditional and conditional rights in contractual settings, as summarized in paragraphs 30 and 31 of this Invitation to Comment and paragraphs BC10–BC13 of the IASB Exposure Draft? If not, why not?

Question 3: If you answer yes to Question 2, do you agree that the IASB has appropriately applied the notion and supporting reasoning referred to therein in the analysis of Examples 1–3 in paragraphs 33–35 of this Invitation to Comment? If not, why not?

Question 4: Do you agree with the IASB's proposal to classify as intangible assets those unconditional rights that are associated with conditional rights and that satisfy the definition of an asset, without shifting the consideration of the uncertainty surrounding the conditional rights from recognition to measurement?

Contingent Liabilities

38. The IASB Exposure Draft proposes to eliminate the term *contingent liability* from its standards. The term *contingent liability* currently refers to either a possible obligation whose existence depends on a future event (paralleling the idea of a contingent asset) or an unrecognized present obligation. The reason for nonrecognition may be either that an outflow of economic resources to settle the obligation is not probable or that the obligation cannot be measured reliably.

39. The IASB's proposal to eliminate the term *contingent liability* from its standards is based on reasoning similar to that given for eliminating the term *contingent asset*. A contractual liability often comprises both an unconditional obligation that meets the definition of a liability and a conditional obligation that may indicate the presence of the related unconditional obligation but is itself only a possible future liability that does not meet the definition of a liability.

40. The IASB uses a product warranty to illustrate unconditional and conditional obligations in a contractual setting. The obligation of the entity issuing the warranty to repair or replace a defective product is a conditional obligation because it depends on whether the product develops a fault and the customer seeks repair or replacement under the warranty. The unconditional obligation is to provide warranty coverage; that is, to stand ready to repair or replace a defective product. When the entity stands ready to repair or replace, it is providing a warranty coverage service that represents an outflow of economic resources. This stand-ready obligation meets the definition of a liability. The conditional obligation or contingency does not determine whether a liability exists; it affects only the amount that will be required to settle the liability.

41. The IASB has extended its reasoning on liabilities from contractual settings to noncontractual settings. For example, if an entity is the defendant in a lawsuit, the contingency is that entity's possible obligation to pay any penalties imposed by the courts. In the IASB's view, this conditional obligation does not meet the definition of a liability. However, it does point to an unconditional obligation (to stand ready to perform as directed by the courts) that does qualify as a present liability.

42. The IASB's reasoning implies that a conditional obligation is always associated with an unconditional obligation in contractual settings. However, that reasoning does not imply that the same relationship always exists in noncontractual settings. The IASB considers as an example an entity that would be required to accept its previously sold products for disposal if a new law to that effect were enacted with retrospective application. The IASB concludes that an unconditional obligation (for example, an obligation to stand ready to accept its sold product for disposal) does not exist. It reasons that only the new law could create such an obligation, and until the new law is enacted, the entity cannot have a present obligation with respect to that law.

43. The IASB emphasizes that under its proposals, an entity is first required to determine whether it has a present obligation that meets the definition of a liability. If it does, then the entity proceeds to recognition and measurement issues. In other words, recognition and measurement considerations are not used to determine whether a liability exists. In the case of unrecognized present obligations, this reasoning implies that it is inappropriate to describe as contingent something that has already been determined to exist. If a present obligation is not recognized because of recognition or measurement issues, that obligation would properly be described as an unrecognized liability.

44. A more extensive discussion of the IASB's reasoning about contingent liabilities is found in paragraphs BC19–BC30 of the IASB Exposure Draft.

Question 5: Do you agree with eliminating the notion of contingent liability? If not, why not?

Question 6: Do you agree with the IASB's analysis of unconditional and conditional obligations in contractual settings, as summarized in paragraphs 39 and 40 of this Invitation to Comment and paragraphs BC24–BC28 of the IASB Exposure Draft? If not, why not?

Question 7: If you answer yes to Question 5, do you agree that the IASB has appropriately applied the notion and supporting reasoning referred to therein in the analysis of the example in paragraph 41 of this Invitation to Comment? If not, why not?

Probability Recognition Criterion

45. In the event that the proposals to eliminate the terms *contingent asset* and *contingent liability* are adopted, the IASB has concluded that the probability recognition criterion used in conjunction with those terms is no longer needed. One of the proposed amendments to IAS 37, therefore, would omit this criterion from the standard.

46. Currently, IAS 37 specifies that a provision is recognized if it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, with *probable* being defined as more likely than not. The IASB notes that in many cases, an entity does not need to assess the probability of an outflow of resources to recognize an item because there is little or no uncertainty that settlement of the obligation will require some outflow of resources. This is the case even if there is significant uncertainty about the amount or timing of the outflow.

47. For liabilities having both unconditional and conditional obligations, the IASB reasons that the probability recognition criterion is currently being applied to the wrong obligation, that is, the conditional obligation. This treatment is conceptually unsatisfactory because the purpose of a recognition criterion is to determine whether an item that meets the definition of a financial statement element should be recognized in the financial statements. The IASB has determined that in both contractual and noncontractual settings a conditional obligation fails to meet the definition of a liability. Therefore, it is inappropriate to apply the probability recognition criterion, or any other recognition criterion, to the conditional obligation. The IASB also has decided that an unconditional obligation associated with a conditional obligation meets the definition of a liability and always satisfies the probability recognition criterion. Because this criterion is not needed in the case of simple liabilities and the unconditional portion of more complex liabilities, and does not apply to the conditional portion of complex liabilities, the IASB proposes to omit it from the amended standard.

48. Omitting the probability recognition criterion from IAS 37 would not mean that every obligation with uncertainty that qualified as a liability under IAS 37 would be recognized as a liability in the financial statements. Recognition criteria other than the probability recognition criterion might apply. However, discontinuing the use of the

probability recognition criterion in the case of liabilities is consistent with shifting the consideration of probability and uncertainty from recognition to measurement as exemplified by Statement 143 and Interpretations 45 and 47.

49. Paragraphs BC36–BC48 of the IASB Exposure Draft discuss in detail the IASB’s basis for conclusions on the probability recognition criterion.

Question 8: Do you agree with omitting the probability criterion for recognition of nonfinancial liabilities? If not, why not?

Measurement

50. Along with proposing to eliminate the term *contingent liability* and omit the probability recognition criterion for liabilities, the IASB also proposes to amend the language of the measurement requirements of IAS 37 to improve clarity of meaning, increase consistency in application, and facilitate the measurement of stand-ready obligations.

51. IAS 37 currently requires that a provision be measured at the best estimate of the expenditure required to settle the present obligation or to transfer it to a third party on the balance sheet date. The IASB has concluded that the measurement principle would be more clearly stated by eliminating any reference to “best estimate” and requiring that an entity measure a nonfinancial 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, which is the current description of best estimate in IAS 37.

52. The IASB notes that the price of many stand-ready obligations (that is, the unconditional obligation in a liability with both unconditional and conditional components) is not readily observable because that price is embedded in the price of a product. However, the IASB also notes that the amount an entity would expect to pay to settle or transfer the stand-ready obligation would reflect the likelihood, amount, and timing of the expected cash flows related to the associated conditional obligation. Thus, the most appropriate way to measure a stand-ready obligation is to use an expected cash flow estimation technique. The IASB has further determined that an expected cash flow approach is appropriate for measuring liabilities for both a large group of obligations and single obligations.

53. Because of confusion in the past about the use of discount rates in measuring liabilities under IAS 37, the IASB has decided to clarify that when discounting is used to measure a nonfinancial liability, a current discount rate should be used both at initial recognition and subsequent remeasurement of the liability. This is equivalent to a market-to-market requirement. The IASB also decided to eliminate from IAS 37 the requirement that future amounts be reflected in the measurement of a liability if there is sufficient objective evidence that they will occur. The reason for this decision is the new emphasis on an expected cash flow approach when market prices are not directly observable. In the expected cash flow approach, the likelihood of future events occurring is reflected in the

probability weighting of the cash flows, and the sufficient objective evidence criterion is meaningless.

54. The increased emphasis on an expected value approach in measurement as well as restriction of the use of probability and uncertainty to measurement, rather than recognition and measurement, would substantially converge IAS 37 with the principles of Interpretations 45 and 47. However, the proposed language of IAS 37 precludes recognition of a liability if the liability cannot be measured reliably.

55. Details about the IASB's reasoning relating to the proposed changes in the measurement of nonfinancial liabilities can be found in paragraphs BC77–BC88 of the IASB Exposure Draft.

Question 9: Do you agree with the proposed measurement requirements for nonfinancial liabilities? If not, why not?

Appendix A

EXCERPTS FROM BASIS FOR CONCLUSIONS ON PROPOSED AMENDMENTS TO IAS 37

A1. The following are excerpts from the Basis for Conclusions of the IASB Exposure Draft, *Amendments to IAS 37 Provisions, Contingent Liabilities and Contingent Assets and IAS 19 Employee Benefits*.

Contingent assets

BC7 A contingent asset is defined in IAS 37 as a ‘possible asset’. A contingent asset arises when it is uncertain whether an entity has an asset at the balance sheet date, but it is expected that some future event will confirm whether the entity has an asset. For example, the Standard explains that an entity pursuing a claim through legal processes (ie a lawsuit), of which the outcome is uncertain, has a contingent asset. Therefore, the lawsuit is not recognised as an asset until it is ‘virtually certain’ that it will result in the realisation of income and can then be regarded as an asset rather than a possible asset.

BC8 The Board considered this example of a lawsuit in the context of a business combination. The Board observed that a lawsuit of an acquiree would have a fair value and would affect the price that an acquirer would be required to pay for the acquiree. However, if the lawsuit was regarded as a contingent asset at the date of the business combination (because it was not virtually certain to give rise to income), the acquirer would not recognise it as a separate asset but would subsume its value into goodwill.

BC9 The Board noted that in IFRS 3 *Business Combinations* it had concluded that goodwill satisfies the definition of an asset. Given this conclusion, the Board questioned the analysis of a lawsuit in IAS 37. The Board reasoned that if goodwill is an asset, any item subsumed within that goodwill (ie any item for which the acquirer paid a price, but which itself does not qualify for recognition separately from goodwill in accordance with IAS 38 *Intangible Assets*) must itself also satisfy the definition of an asset in the *Framework*. The Board noted that the lawsuit would be a specific item within goodwill, for which the acquirer would be required to pay, and therefore concluded that it must be an asset and not a possible asset.

BC10 Therefore, the Board reconsidered the analysis of the lawsuit in IAS 37 and, to do so, it turned to tentative decisions it had reached in its Revenue Recognition project, particularly its decisions relating to contractual rights and obligations.

BC11 In its Revenue Recognition project, the Board noted that contractual rights and obligations can be divided into two types: conditional (ie performance is subject to the occurrence of an event that is not certain to occur) and unconditional (ie nothing other than the passage of time is required to make its performance due).

The Board also noted that although unconditional contractual rights and obligations may exist on their own, conditional contractual rights and obligations are accompanied by associated unconditional rights and obligations. The Board tentatively concluded that assets and liabilities arising from contracts derive only from *unconditional* (or non-contingent) rights and obligations, and not from conditional (or contingent) rights and obligations. This is because a conditional right to future economic benefits is not a resource controlled by the entity. Similarly, a conditional obligation that may result in an outflow of economic benefits is not a present obligation. However, although a conditional right or obligation in a contract does not itself satisfy the definition of an asset or liability, it points to the existence of an accompanying unconditional right or obligation that may satisfy the definition of an asset or liability.

- BC12 This analysis of conditional and unconditional rights and obligations can be illustrated with an example of an entity that has an insurance contract. Some might describe the entity's asset as the possible reimbursement. However, the entity is entitled to reimbursement only if it incurs an insured loss. Therefore, its right to reimbursement is *conditional* (or contingent), because something other than the passage of time is required before the entity can benefit from the reimbursement. Because the right is conditional, it cannot satisfy the definition of an asset in the *Framework*—it is not a *present* right. However, the insurance contract has given the entity another right, one that is similar to an option on shares of a particular entity. The holder of an option on shares does not own the shares, but the right to buy the shares at a stipulated price and date. The insurance contract grants the entity a similar right, namely the right to insurance coverage, and, as with the rights in an option on shares, this right is *unconditional*. It is the unconditional contractual right to insurance coverage that satisfies the definition of an asset.
- BC13 The Board noted that this analysis of an insurance contract highlights that determining whether the entity has an asset (ie an unconditional right) is independent of the probability of the occurrence of the contingency (ie incurring an insured loss). Expressed another way, the contingency does not confirm or establish whether there is an asset, rather it affects the value of the future economic benefits embodied in the asset.
- BC14 In its Revenue Recognition project, the Board made its tentative decisions about conditional and unconditional rights and obligations in the context of considering *contractual* rights and obligations. Nonetheless, the Board decided that its analysis of the relationship between conditional and unconditional contractual rights could be applied more widely. In particular, it could be used to refine the analysis of items described in IAS 37 as contingent assets. For example, the Board observed that a lawsuit could be analysed into two rights: the entity's conditional right to compensation (ie conditional upon the outcome of the legal process) and its unconditional right to have its claim for recovery of damages caused by the defendant considered by the courts. In other words, although any compensation

- that the entity might receive as a result of successfully pursuing its claim is a conditional right, the pursuit of the lawsuit satisfies the definition of an asset.
- BC15 The Board concluded that the foregoing would be a better analysis of the lawsuit than that provided by IAS 37. This is because by analyzing transactions into unconditional and conditional rights, it is possible to identify the underlying asset better. In other words, it facilitates addressing the question of whether the entity controls a resource at the reporting date and, hence, has satisfied the definition of an asset. In contrast, an entity applying IAS 37 considers the possible inflow of economic benefits (ie the conditional right) and applies a ‘virtually certain’ probability recognition criterion to determine when those possible benefits have given rise to an asset. However, as noted above, a conditional right does not give rise to an asset and, therefore, regardless of the probability of an inflow of benefits, should not be recognised.
- BC16 The Board considered some other examples of contingent assets. Two examples are an entity that has applied for an operating licence and an entity that is negotiating a significant contract with a customer with whom it has had no prior contractual relationship. In these two examples, the Board concluded that the operating licence and the contract are conditional rights. This is because the rights are conditional (or contingent) on a future event (ie decision of the awarding authority or the customer signing the contract). However, in both cases the entity has an asset. In the case of the licence application, the asset arises from the entity’s unconditional right to participate in the process of bidding for the licence. In the case of a pending customer contract, the asset arises from the entity’s unconditional right to the economic value of the developing contractual relationship.
- BC17 As a result of analysing items previously described as contingent assets into conditional and unconditional rights, the Board decided to eliminate the term ‘contingent asset’. The Board concluded that the term was troublesome and confusing. As already noted, assets arise only from unconditional (ie non-contingent) rights. Hence, an asset, which embodies an unconditional right, cannot be described as contingent or conditional. Furthermore, because conditional or contingent rights do not by themselves give rise to assets, it is inconsistent with the *Framework* to recognise them, even if it is virtually certain that they will become unconditional or non-contingent. Therefore, instead of using the term ‘contingent’ to refer to uncertainty about whether an asset exists, the Board decided that the term should refer to one or more uncertain future events, the occurrence (or non-occurrence) of which affects the amount of the future economic benefits embodied in an asset.
- BC18 The Board also decided that it would be more logical to include in IAS 38 the discussion about assets with contingencies. This is because such an asset would be a non-monetary asset without physical form. Hence, if it is *identifiable* (ie if it is separable or arises from contractual or other legalrights) it would, by definition, be

an intangible asset. The Board acknowledged that if an intangible asset arising from an unconditional right accompanied by a conditional right is within the scope of IAS 38 and has not been acquired in a transaction, the requirements of IAS 38 impose a high recognition threshold. (If acquired in a business combination or otherwise, the intangible asset is recognised at fair value. Therefore, uncertainty about the conditional right is reflected in the measurement of the asset.) However, the Board decided that it was outside the scope of this project to revisit the requirements in IAS 38.

Contingent liabilities

BC19 The Board then considered contingent liabilities. The Board observed that in contrast to the definition of a contingent asset, the present definition of a contingent liability includes two notions. The first notion, a possible obligation, is symmetrical with the definition of a contingent asset and arises when the existence of a present obligation at the balance sheet date is uncertain, but some future event will confirm whether the entity has that obligation. The second notion, an unrecognised present obligation, arises when the entity has a present obligation, but that obligation is not recognised as a liability, because either an outflow of economic resources to settle the obligation is not probable or the entity is not able to measure the obligation reliably.

Possible obligations

BC20 The Board had previously considered such obligations in the context of a business combination. In IFRS 3, it specified that an acquirer should recognise at the acquisition date the acquiree's contingent liabilities—and hence its possible obligations—if their fair values could be measured reliably.

BC21 In arriving at this requirement in IFRS 3, the Board took the view that the existence of possible obligations in an acquiree point to the existence of present obligations and, therefore, if their fair value could be measured reliably, the possible obligations should be recognised as liabilities. Furthermore, the Board concluded that it was appropriate that an acquiree's possible obligations should be recognised as liabilities as part of the process of allocating the cost of the business combination, because they have the effect of reducing the price that an acquirer is prepared to pay for the acquiree. In effect, the acquirer is paid to assume an obligation by paying a reduced purchase price for the acquiree.

BC22 In the light of its observations about unconditional and conditional rights and obligations and its conclusions about contingent assets described above, the Board decided that it could refine its conclusions in IFRS 3. It reasoned that its revised analysis of items previously described as contingent assets was also applicable to items previously described as contingent liabilities (possible obligations). The Board also noted that if it refined the analysis of items described as contingent liabilities in IAS 37, there would be no need to specify different requirements for

such items in a business combination. Furthermore, all such items would be treated consistently, regardless of whether they are acquired in a business combination or generated internally (subject to the different measurement requirements of IAS 37 and the revised IFRS 3).

BC23 Accordingly, the Board decided to eliminate the term ‘contingent liability’. Instead of using ‘contingent’ to refer to uncertainty about whether a liability exists, the Board decided that the term should refer to one or more uncertain future events, the occurrence (or non-occurrence) of which affects the amount that will be required to settle an obligation.

BC24 These conclusions mean that, for example, an entity that issues a product warranty has a liability arising from its unconditional obligation to provide warranty coverage over the term of the warranty (ie to provide a service). Uncertainty about whether the product will develop a fault, and hence require repair or replacement (ie the contingency), relates to whether the entity’s conditional obligation to repair or replace the product if it develops a fault will become unconditional. (The entity’s obligation to repair or replace the product is conditional because it depends on whether the product develops a fault.) Hence, the contingency does not determine whether the entity has a liability to provide warranty coverage. Rather, it affects the amount that will be required to settle the obligation. Similarly, in the case of an entity defending a lawsuit, the entity has a liability arising from its unconditional obligation to perform as directed by the courts. The contingency relates to the entity’s conditional obligation to pay any penalties imposed by the court and affects the amount that will be required to settle the liability.

BC25 The Board’s conclusions about the nature of the unconditional obligation in a warranty contract are consistent with the conclusions of the US Financial Accounting Standards Board (FASB) in Interpretation No. 45 *Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (FIN 45), although the recognition and measurement requirements of FIN 45 do not apply to product warranties issued by an entity. FIN 45 describes the unconditional obligation as an ‘obligation to stand ready to perform over the [contract] term’. Whilst the notion of an obligation to stand ready is derived from FASB Concepts Statement No. 6 *Elements of Financial Statements* (Concepts Statement 6), the Board decided to introduce the term into IAS 37 because it regards it as a helpful way of capturing the nature of the liability.

BC26 The Board acknowledged that its analysis of unconditional and conditional rights and obligations may appear complex and that some constituents may already have regarded some examples of liabilities arising from unconditional obligations accompanied by conditional obligations (eg product warranties) as examples of liabilities. Indeed, the Board noted that many financial liabilities within the scope of IAS 39 *Financial Instruments: Recognition and Measurement* could be analysed as containing both a conditional and unconditional obligation. However,

as noted with assets, the objective of analysing transactions into unconditional and conditional obligations is to assist in identifying precisely the liability in existence at the balance sheet date, rather than relying on an assessment of some uncertain future event to determine whether a liability exists at that date. The Board concluded that if the liability is identified and accounted for, there is no need to identify the two obligations. Nonetheless, the Board observed that in practice the conditional obligation is sometimes the more readily identifiable obligation. Thus it can be used as a pointer to any associated unconditional obligation. Furthermore, the Board noted that it can be important to distinguish between the two obligations because, as discussed below, the probability recognition criterion in the *Framework* should be applied to the liability (ie unconditional obligation) rather than to the conditional obligation.

BC27 The main difference between the approach in the draft Standard to items previously described as contingent liabilities and that in the current version of IFRS 3 is that an entity is required to determine whether it has a present obligation that satisfies the definition of a liability before considering recognition and measurement. Put another way, the draft Standard does not use either recognition or measurement as a means of resolving uncertainty about whether a liability *exists*. As discussed in paragraph BC41 below, this is consistent with the *Framework*. In contrast, in the current version of IFRS 3, the contingent liability itself is recognised, and the measurement of the contingent liability reflects the uncertainty about whether the contingent liability had given rise to a present obligation. Therefore, the approach in the draft Standard places greater emphasis on determining whether the definition of a liability has been satisfied and does not allow recognition of possible liabilities. This is consistent with the overall objective of the second phase of the Business Combinations project in which an acquirer recognises the assets acquired and liabilities assumed at the date control is obtained. The Board also noted that the approach is consistent with recent standards of the FASB on liabilities that have adopted a fair value measurement basis. For example, both Statement No. 143 *Accounting for Asset Retirement Obligations* (SFAS 143) and Statement No. 146 *Accounting for Costs Associated with Exit or Disposal Activities* (SFAS 146) prohibit the recognition of obligations that do not satisfy the definition of a liability in Concepts Statement 6.

BC28 However, although the proposed approach is different from that in IFRS 3, the Board emphasises that its proposals should not be regarded as a reversal of the requirement in IFRS 3 to recognise contingent liabilities. Rather, they should be viewed as a refinement of that earlier decision. Indeed, the Board observed that in most cases there would be no change in obligations recognised in accordance with the existing and proposed revised versions of IFRS 3. This is because some obligations previously described as contingent liabilities were, in fact, unrecognised *liabilities* and, therefore, will be recognised in a business combination in accordance with the proposed revised IFRS 3. In addition, in many cases, items previously described as possible obligations will be analysed more precisely into two obligations: an unconditional obligation and a conditional

obligation. The effect of recognising the liability resulting from the unconditional obligation at fair value in accordance with the proposed revised IFRS 3 would be similar to recognising the contingent liability at fair value in accordance with the existing version. This is because the measurement of the liability will reflect the uncertainty about the conditional obligation.

BC29 Nonetheless, the Board observed that not all items previously described as contingent liabilities satisfy the definition of a liability in the *Framework*. This is because some such items contain only a conditional (or contingent) obligation and no unconditional obligation. Therefore, an item that might have been recognised in accordance with the current version of IFRS 3 will no longer qualify for recognition in accordance with the draft Standard or revised version of IFRS 3. For example, the Board considered a scenario in which an entity would be required to take back previously sold products for disposal if a new law were passed (in other words, the new law would have a retrospective effect). The Board noted that until the new law is substantively enacted, the entity would have no present unconditional obligation (unless the entity by its own actions created a constructive obligation before the law was enacted). Hence, the entity would have only a conditional obligation to take back products and, therefore, no liability. Expressed another way, the Board concluded that an entity does not have a stand ready obligation with respect to a possible change in the law. This is because it is the new law that creates new obligations and until the law is substantively enacted those obligations do not exist. Accordingly, an entity cannot have a present obligation with respect to that law.

Unrecognised present obligations

BC30 Having decided to eliminate the term ‘contingent liability’, the Board considered the notion of an unrecognised present obligation in IAS 37, which is also described as a contingent liability. As noted above, liabilities arise only from unconditional obligations. Hence, something that is a present obligation cannot be described as being contingent. The Board also noted that there was no need to define liabilities that fail to qualify for recognition because they can be described as unrecognised liabilities. Therefore, the Board does not propose to define such liabilities. Consistently with the current requirements in IAS 37 for contingent liabilities, liabilities that are not recognised in accordance with the draft Standard are required to be disclosed.

Probability recognition criterion

BC36 Having refined its analysis of items previously described as contingent liabilities, the Board concluded that it would need to reconsider the probability recognition criterion in IAS 37.

BC37 Paragraph 14(b) of IAS 37 specifies that a provision is recognised ‘if it is probable that an outflow of resources embodying economic benefits will be required to

settle the obligation’, ‘probable’ being defined as ‘more likely than not’. The Board noted that in many cases, an entity does not need to make any assessment of the probability of an outflow because there is little or no uncertainty that settlement of the obligation will require *some* outflow of resources embodying economic benefits, even if there is significant uncertainty about the amount or timing of the outflow. An example is an entity that has an obligation to decommission a nuclear power station.

BC38 However, the Board noted that in some other cases application of the probability recognition criterion in IAS 37 was more troublesome. For example, in the case of a guarantee, Example 9 in the Standard explains that a guarantor applies the criterion by considering the probability of having to make a payment under the guarantee. This means that if the guarantee is issued in exchange for a fee, and it is not probable that a payment will be required under the guarantee, the guarantor does not recognise a liability. In the absence of the revenue recognition requirements of IAS 18, the entity would recognise a gain. This accounting is counter-intuitive, because an entity that has been paid to assume an obligation would recognise a gain on initial recognition, followed by losses if payments under the guarantee are made.

BC39 The Board acknowledged that in practice many guarantees within the scope of IAS 37 would be recognised because the Standard requires entities to consider recognition by reference to a portfolio (or class) of similar obligations. Thus, although it might not be probable that a payment will arise from a single guarantee, it is probable that *some* payment will arise in a portfolio of guarantees and, therefore, a liability is recognised. However, the Board decided that resolving a troublesome recognition issue in this way (ie by requiring recognition on a portfolio basis) is conceptually unsatisfactory. It would be better if the probability recognition criterion could be applied consistently for single guarantees and portfolios of guarantees.

BC40 Having analysed the obligations in transactions such as guarantees and warranties into conditional and unconditional obligations, the Board observed that the probability recognition criterion in IAS 37 is sometimes applied to the ‘wrong’ obligation. This is because it is applied to the conditional obligation (ie the contingency) rather than the unconditional obligation (ie the contractual stand ready service obligation). For example, in the case of a guarantee, it is applied to the guarantor’s conditional obligation to make a payment under the guarantee. Similarly, in the example of a product warranty (Example 1 in the Standard), the criterion is applied to the entity’s conditional obligation to repair or replace the product.

BC41 The Board concluded that applying the probability recognition criterion to the conditional obligation conflicted with the *Framework*. This is because paragraph 82 of the *Framework* describes recognition as ‘the process of incorporating in the balance sheet or income statement an item *that meets the definition of an element*’

(emphasis added). In other words, the *Framework* requires an entity to determine whether a liability exists before considering whether that liability should be recognised. As explained in paragraph BC24, in the case of a guarantee or a product warranty, the liability that is being considered for recognition is the unconditional obligation to stand ready to provide a service over the period of the guarantee or the product warranty. It is not the conditional obligation to make a payment under the guarantee or to repair or replace the product. Hence, the question is whether settlement of the present obligation (ie the unconditional obligation) to provide a service will probably result in an outflow of economic benefits, and not whether the conditional obligation to make a payment or to repair the product will probably result in an outflow of resources.

BC42 The *Framework* articulates the probability recognition criterion in terms of a flow of economic benefits. It also explains that the outflow required to settle a liability can occur in various ways. In particular, it explains that the outflow of resources can be the provision of services. The Board reasoned that because an entity that issues a guarantee or a product warranty has an obligation to provide a service—because it is contractually obliged to honour claims—the outflow of resources that is required to settle this obligation should be regarded as the provision of services over the term of the contract, and not the possible payments under the guarantee or product warranty.

BC43 Viewing the outflow of resources as the provision of services means that an entity that issues a guarantee or a product warranty satisfies the probability recognition criterion by definition. This is because it is certain that the stand ready obligation would require an outflow of resources in settlement. The assessment of the probability of an outflow of resources is independent of the likelihood of a claim arising under the guarantee or product warranty. In other words, even if it is highly unlikely that a claim will arise, the probability recognition criterion is still satisfied. As noted above, the probability of a claim arising relates to the likelihood of the *conditional* obligation becoming a present obligation. Accordingly, the Board concluded that the probability of a payment or claim arising under a guarantee or warranty should not determine whether the entity's *present* obligation to provide a service should be recognised. Rather, the likelihood of claims arising should be reflected in the measurement of that present obligation.

BC44 The Board's conclusions about the application of the probability recognition criterion in the case of warranties and guarantees are consistent with FIN 45. This Interpretation explains that a guarantor has incurred a liability on issuing a guarantee that qualifies for recognition, even if it is not probable that the specified triggering events or conditions that would cause payments under the guarantee will occur. The FASB concluded that the outflow of resources associated with the unconditional obligation to stand ready to perform over the term of the guarantee is the requirement to 'stand ready to provide services' and not the possible payments required under the guarantee.

- BC45 The Board observed that its analysis of the application of the probability recognition criterion to a guarantee or product warranty could be extended to any liability arising from an unconditional contractual obligation accompanied by a conditional obligation. This is because such liabilities arise from the contractual obligation to stand ready to provide a service. For example, an entity that is jointly and severally liable with another entity, but expects that other entity to be responsible for the obligation, is providing a service to the counterparty because the counterparty has the right to look to the entity to honour the obligation (ie the entity is standing ready to honour the obligation). Similarly, a retailer that is obliged, contractually or constructively, to offer refunds to dissatisfied customers is providing a service to its customers because those customers have a right to return their products (ie the retailer is standing ready to accept returns).
- BC46 The Board then considered liabilities that accompany non-contractual contingent liabilities. As noted above, the Board decided that the relationship between conditional and unconditional contractual obligations could be extended to non-contractual obligations. For example, in the case of a lawsuit, the Board observed that although the penalties that a defending entity might be required to pay are a conditional obligation, the entity has no discretion to do otherwise than perform as directed by the court. Therefore, the Board concluded that the entity also has a present (ie unconditional) legal obligation, namely an obligation to stand ready to pay any penalties awarded by the court. Because the outflow of resources is the standing ready (ie the provision of a service), rather than the possible damages, the Board concluded that the probability recognition criterion is satisfied. It is certain that the entity is obliged to accept any obligation imposed by the court. In effect, the court's ability to impose settlement stands in the place of a contract.
- BC47 The Board observed that the above conclusions about the application of the probability recognition criterion mean 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. Therefore, the Board considered whether it should retain the probability recognition criterion in the Standard. The Board noted that the criterion might be misapplied in some situations. In particular, it might be applied to the entity's conditional obligation rather than to its present obligation, in cases in which an entity has two obligations, with the result that liabilities are not recognised. The Board also noted that there is anecdotal evidence to suggest that some use the criterion to determine whether they have incurred a liability, instead of determining whether the definition of a liability has been satisfied. This could result in an entity that has a conditional obligation with a very high probability of an outflow of economic benefits concluding that it should recognise a liability. However, if the definition of a liability is not satisfied (in particular, if there is no present obligation), the entity should not recognise a liability. Similarly, relying on the probability recognition criterion to determine whether a constructive obligation exists could result in the recognition of items that are not liabilities. This is because in some cases an entity may conclude that there will probably be

an outflow of economic benefits, even though it has no *obligation* to incur that outflow. Lastly, the Board noted that it would add unnecessary complexity to the Standard to specify a criterion that is always satisfied. Therefore, the Board decided to omit the criterion from the draft Standard.

BC48 The Board acknowledged that the criterion is derived from the *Framework* and, therefore, not including the criterion in the Standard might give the impression of inconsistency with the *Framework*. Indeed, the Board was aware that many of its constituents regard some of its recent Standards as inconsistent with the *Framework* because they do not contain a probability recognition criterion. However, the Board concluded that there would be no inconsistency. The apparent inconsistency arises only if the conditional or contingent obligation is being considered rather than the unconditional obligation. Having refined the analysis of liabilities in IAS 37 to focus on the unconditional obligation, the Board concluded that it was inevitable that the current interpretation of the probability recognition criterion in IAS 37 would need to be reconsidered. Nonetheless, the revised interpretation is consistent with the *Framework*. Furthermore, it results in consistent recognition of contractual obligations in accordance with IAS 37 and IAS 39, because the probability recognition criterion in the *Framework* is being applied in the same way in both Standards. For example, in considering the recognition of an option in accordance with IAS 39, an entity does not consider whether it is probable that the option will be exercised. Rather, the probability recognition criterion is applied to the unconditional obligation.

Measurement

BC77 The Board observed that the FASB has adopted a fair value measurement objective on initial recognition of a liability in some of its recent Statements (including SFAS 146). This is because the FASB believes fair value is the most relevant and faithful representation of the underlying economics of a transaction. IAS 37, on the other hand, requires provisions to be measured at the best estimate of the expenditure required to settle the present obligation or to transfer it to a third party on the balance sheet date.

BC78 The IAS 37 requirement can be interpreted as being similar to fair value, but the Board acknowledges that the requirement leaves some issues unresolved. The Board concluded that it would be inappropriate to make fundamental changes to the measurement objective of the Standard in this project given the Board's more far-reaching project on the conceptual framework. Nonetheless, the Board noted that it would be awkward to apply some of the present measurement requirements to stand ready obligations (ie unconditional obligations accompanied by conditional obligations). In addition, the Board was concerned that the measurement requirements are not always consistent and can be interpreted in different ways. Therefore, the Board proposes some amendments to these requirements.

Amount that an entity would rationally pay to settle or transfer the obligation

BC79 The Board concluded that the present explanation of best estimate in paragraph 37 of IAS 37 as ‘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’ should be the measurement objective of the Standard. The Board believes that this phrase sets out a clearer principle for measuring liabilities and is less likely to be misinterpreted than the notion of ‘best estimate’.

Use of expected cash flow estimation technique

BC80 The Board noted that in some cases, a stand ready service obligation might be separately priced, for example, in the case of some product warranties. However, the Board noted that in many cases there would be no directly observable market price for such obligations, for example in the case of a disputed lawsuit or a warranty included in the price of a product. The Board noted that in such cases an entity would need to use a surrogate for measuring the service obligation. The Board noted that the amount an entity would expect to pay to settle the service obligation (ie stand ready obligation) would reflect the likelihood, amount and timing of the expected cash flows attaching to the conditional obligation. Thus, the most appropriate way to measure such an obligation is to use an expected cash flow approach.

BC81 However, IAS 37 suggests that using an expected cash flow approach is most appropriate for a large population of items. In contrast, it specifies that ‘the individual most likely outcome may be the best estimate of’ a single obligation. Hence, if an entity has a 60 per cent chance of losing a court case at a cost of CU1 million and a 40 per cent of winning at no cost, the Standard could be interpreted to require the liability to be measured at CU1 million. The Board, however, observed that measuring a liability at the ‘most likely outcome’ conflicts with the principle of measuring liabilities at the ‘amount that an entity would rationally pay to settle the obligation ... or to transfer it to a third party’. The Board reasoned that if management concluded that there was a chance of settlement at no cost, it would not settle the obligation for the maximum amount that might be required. Rather, management would take into consideration the expected value of the potential outcomes. The Board also noted that measuring a liability at its most likely outcome fails to reflect the uncertainty inherent in the obligation. This can therefore result in two obligations with different risks and uncertainties being measured at the same amount.

BC82 Accordingly, the Board decided to emphasise that an expected cash flow approach, which is currently cited as an estimation method that can be used as a basis for measuring liabilities for a large population of items, is also appropriate for single obligations.

Discount rate

BC83 The Board noted that in practice, before IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities* was issued, there was some confusion about whether IAS 37 required a current discount rate to be used both on initial recognition and on subsequent measurement. Therefore, in the draft Standard, the Board decided to clarify that when discounting is used, the rate is a current rate at each balance sheet date. The Board acknowledges that in relation to subsequent measurement of a liability this is different from SFAS 143 and SFAS 146. However, the Board believes that the use of a current rate is both more representationally faithful and consistent with the existing requirements of IAS 37.

Future events

BC84 IAS 37 currently specifies that future amounts should be reflected in the measurement of a liability if there is sufficient objective evidence that they will occur. Therefore, for example, in measuring an obligation to clean up environmental contamination, an entity should not anticipate the development of a completely new technology for cleaning up unless that technology is supported by sufficient objective evidence. However, it would be appropriate for the entity to reflect the expected benefits of the effects of increased experience in applying existing technology.

BC85 The Board noted that this requirement conflicts with measuring obligations using an expected cash flow approach. For example, an entity that is measuring a product warranty obligation with no observable market price would consider the likelihood that claims will occur, and the amount and timing of the cash flows that will be required to meet those claims. Read literally, IAS 37 suggests that the likelihood of future claims arising would be reflected in the measurement of a liability only if there is sufficient objective evidence that they would occur. Accordingly, some (possibly all) of the cash flow scenarios that should be considered in measuring the liability might be inappropriately disregarded.

BC86 The Board reasoned that if an expected cash flow approach is used appropriately, there is no reason why an entity should not use assumptions about future events that affect the amount required to settle an obligation, regardless of whether there is 'objective evidence' about those events occurring. This is because in an expected cash flow calculation, the likelihood of those events occurring will be reflected in the probability weighting applied to the cash flows. Thus, for example, an entity measuring a clean-up obligation should make assumptions about future changes in technology, as long as the probability weighting applied to those assumptions appropriately reflects the likelihood that the change in technology will occur.

BC87 Therefore, the Board decided to withdraw the requirement for future events that affect the amount that will be required to settle the obligation to be included in the

measurement of that obligation only if there is sufficient objective evidence that they will occur. Although some may be concerned that this could result in unrealistic assumptions being used in the measurement of a liability, the Board noted that the measurement requirement in IAS 37 encompasses a settlement notion. This enforces discipline in measuring a liability because an entity is required to consider what a counterparty would demand to assume the liability.

BC88 The Board also decided to amend former paragraph 50 to specify that the effect of possible new legislation should not be reflected in the measurement of a liability. The Board reasoned that if, as discussed in paragraph BC29, there is no obligation until the law is substantively enacted (ie until the new law exists), it would be inconsistent to measure an *existing* obligation taking into account a possible change in the law. Accordingly, an entity that has an existing legal obligation to clean up contamination in a country in which the government is considering amending the law and requiring a higher standard of clean-up, should treat the change in the law as changing the nature of the underlying obligation. Therefore, it gives rise to a new obligation rather than changing the amount required to settle the existing obligation.