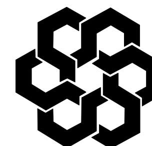

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International Accounting Standards Board

IAS 37 Round-table Discussions: Background materials

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London, UK – 8 December 2006
Melbourne, Australia - 20 December 2006

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INTRODUCTION

1. The International Accounting Standards Board published its Exposure Draft (ED) of Proposed Amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and IAS 19 *Employee Benefits* (ED) in June 2005. The comment period ended on 28 October 2005 and the Board received 123 comment letters.[1]

2. The Board's main objective in amending IAS 37 is to analyse transactions or events in terms of *liability* recognition and measurement. The proposals in the ED take as their starting point the definition of a liability in the *Framework* – 'a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow of economic benefits.'[2] The Board believes that the output of this project will be an important building block for other projects, such as revenue recognition, government grants and leasing. The Board therefore decided to seek further views by holding round-table discussions to debate the proposed amendments to IAS 37.[3]

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[1] The ED and all comment letters are available on the IASB Website: http://www.iasb.org/Current+Projects/IASB+Projects/Liabilities/Exposure+Draft+of+Proposed+Amendments+to+IAS+37+Provisions+Contingent+Liabilities+and+Contingent+Ass/Comment+Letters/Comment+Letters.htm

[2] *Framework*, paragraph 49(b).

[3] Five round-table discussions will be held in Norwalk, London and Melbourne in November and December 2006. More than 75 organisations from 12 different countries will participate in these discussions.

Objective of round-table discussions

3. The round-table discussions will focus on issues associated with the liability recognition and measurement principles proposed in the ED. The main objective of the discussions is to hear participants' views on the tentative conclusions reached by the Board after its redeliberation of these issues (rather than views on the proposals in the ED). The discussions will also provide the Board with an opportunity to explain further the principles underlying the proposed amendments to IAS 37 and to outline developments in its thinking since the ED was published. The agenda also allows time to discuss participants' views on other amendments proposed in the ED.

4. The Board will consider the input from all the round-table discussions at its Board meeting in January 2007. The discussions are expected to aid the Board in planning the next steps in this project.

Purpose of this paper

5. This paper summarises the tentative conclusions reached by the Board after redeliberating the recognition and measurement principles proposed in the ED.

6. Reflecting the agenda for the round-table discussions, this paper has five sections:

   A. Existence of a present obligation

   B. Uncertainty about an outflow of economic benefits

   C. Related amendments

   D. Measurement

   E. Other amendments proposed in the ED

7. As the starting point for discussion the paper poses questions that focus on the most problematic issues being considered by the Board. Additional topics may be raised either by Board members or by other participants.

A. EXISTENCE OF A PRESENT OBLIGATION

Principle

8. The proposed recognition principle underpinning the ED is: An entity shall recognise a liability when (a) the definition of a liability is satisfied, and (b) the liability can be measured reliably.[4] This section focuses on the first aspect of the liability definition – the existence of a present obligation.

Uncertainty about the existence of a present obligation

Issue summary

9. IAS 37 explains that a present obligation (rather than a business risk) exists when a past transaction or event creates an obligation that an entity has little, if any, discretion to avoid because settlement can be enforced by law. This explanation was carried forward in the ED.[5]

10. In many circumstances there is little doubt that a present obligation exists. For example, few dispute that a retailer has a present obligation when a contract, law or regulation requires the retailer to repair or replace a faulty product within twelve months of the date of sale. Similarly, few dispute that a mining company has a present obligation to make good damage to the environment caused by its past mining activities if the mining company is operating in a jurisdiction with applicable environmental restoration and rehabilitation laws.

11. However, sometimes the existence of a present obligation is uncertain.[6] For example, before the balance sheet date an allegation of product mis-selling might be made against a regulated financial services organisation (a breach of industry regulations). But on the balance sheet date, investigations might be incomplete.

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[4] ED, paragraph 11.

[5] IAS 37, paragraph 17 and ED, paragraphs 13 and 14. IAS 37 also explains that a present obligation exists when an entity's past action(s) create(s) a constructive obligation. The Board plans to redeliberate issues associated with constructive obligations in 2007. The discussion in this paper is limited to legal obligations.

[6] The term 'element uncertainty' is sometimes used to describe uncertainty about the existence of a present obligation.

Therefore it is not certain that the organisation has breached industry regulations. This might be because the facts relating to the alleged product mis-selling are disputed, or because there is uncertainty about the outcome of the investigation.

12. Similarly, the existence of a present obligation might be uncertain when it is not clear how the courts will apply existing law to known facts and circumstances. For example, a car manufacturer may be involved in litigation to establish whether existing law requires it to pay the medical costs of individuals suffering from respiratory illnesses known to be caused by carbon dioxide emitted from the cars it manufactured.[7]

13. IAS 37 provides limited guidance on how an entity should address uncertainty about the existence of a present obligation. Paragraphs 15 and 16 explain that an entity should consider all available evidence about circumstances that existed at the balance sheet date (including events after the balance sheet date that provide evidence of conditions that existed at the balance sheet date). A past event is deemed to give rise to a present obligation if, taking into account all available evidence, it is more likely than not that a present obligation exists on the balance sheet date. The ED proposes even less guidance, stating only that an entity should consider all available evidence about circumstances that existed at the balance sheet date (including events after the balance sheet date). The 'more likely than not' criterion has not been carried forward.

Redeliberations

14. The Board has decided to provide more guidance on determining whether a present obligation exists when its existence is uncertain. To address this issue, it

[7] However, it is important to distinguish between uncertainty about the existence of a present obligation and uncertainty about the measurement of a certain present obligation. This distinction is particularly important in the context of IAS 37 because legal and regulatory process can be used to resolve disputes about the financial consequences of known past transactions or events that gave rise to a liability (as well as resolving disputes about the existence of a present obligation). In the example in paragraph 12, the court might determine that the law requires the car manufacturer to pay the medical costs of individuals suffering from respiratory illnesses known to be caused by carbon dioxide emitted from the cars it manufactured (ie a present obligation exists). But the car manufacturer might then be involved in another lawsuit to determine the amount of medical costs it should pay each individual to settle its obligation.

intends to explore whether it is possible to develop indicators. In the context of IAS 37 the indicators might include past experience with similar items, the experience of other entities with similar items, independent professional advice on the application of available reference material (contracts, laws, published policies and procedures) and context (geographical location and social and political environments).

15. The Board has also noted that indicators alone may not resolve this issue satisfactorily. The Board has therefore acknowledged that it might be necessary to reinstate a 'more likely than not' criterion (paragraphs 15 and 16 of IAS 37). In making this observation, the Board emphasised that any 'more likely than not' criterion would be used as a practical expedient to determine whether a present obligation *exists*. It would not be used to determine whether a liability should be *recognised*. (The need for a probability recognition criterion in IAS 37 is discussed in section B.)

Question 1

Do you agree that indicators are an appropriate form of guidance to help an entity to determine whether a present obligation exists on the balance sheet date? If so, what kind of indicators would you include in the standard? If not, what form of guidance would you find useful in determining whether a present obligation exists on the balance sheet date?

Lawsuits

Issue summary

16. Many comment letters used the example of litigation to illustrate uncertainty about the existence of a present obligation. Almost all also challenged the conclusions in Illustrative Examples 1 and 2 accompanying the ED.

17. In Example 1 (disputed lawsuit) an entity is being sued for allegedly selling harmful food. The entity disputes that it sold harmful food and its lawyers advise

that the entity is unlikely to be found liable. Nonetheless, Example 1 concludes that the start of legal proceedings is the past event that gives rise to a present obligation. This is because the start of legal proceedings obliges the entity to act as the court directs. Even if the entity does not believe it is liable, the plaintiff would not be willing to settle the lawsuit on the balance sheet date without compensation. Similarly, a third party would not be willing to assume responsibility for the lawsuit without compensation.

18. In Example 2 (potential lawsuit) a patient dies as a result of a mistake in an operation. The hospital is aware of the mistake. On the balance sheet date legal proceedings have not started. Example 2 concludes that the hospital has a present obligation as a result of the operation in which negligence occurred.

Redeliberations

19. The Board acknowledges that lawsuits are particularly problematical when determining whether a present obligation exists on the balance sheet date. This is because lawsuits often include multiple layers of uncertainty. The Board also acknowledges that the conclusions in Illustrative Examples 1 and 2 are contradictory. That is to say, the ED was not clear whether the underlying event (selling harmful food or negligence) gives rise to a present obligation, or whether legal proceedings (a claim against the entity) gives rise to a present obligation.

20. The Board has reconsidered Illustrative Example 1 and concluded that the ED was incorrect. That is to say, the Board no longer believes that the start of legal proceedings, in itself, is the past event that gives rise to a present obligation. Rather, the start of legal proceedings is one piece of evidence that may be relevant when an entity takes into account all available evidence to determine whether a present obligation exists on the balance sheet date.

21. The Board has also reconsidered Illustrative Example 2 and continues to believe that the conclusion in the ED is appropriate. In other words, a present obligation exists when an entity knows a past action breached a contract or violated a law or

regulation. External detection of a breach or violation is not relevant in determining whether a present obligation exists. (However, the likelihood of detection would affect measurement: see section C.)

Question 2

(a) Do you agree that the start of legal proceedings, in itself, is not a past event that gives rise to a present obligation?

(b) Do you agree that a present obligation exists when an entity knows that a past action breached a contract or violated a law or regulation? If so, do you agree that external detection of a breach or violation is not relevant in determining whether a present obligation exists? If not, why not?

B. UNCERTAINTY ABOUT AN OUTFLOW OF ECONOMIC BENEFITS

Principle

22. This section continues to analyse the definition of a liability and focuses on the phrase 'expected to result in an outflow of economic benefits' in the *Framework's* definition of a liability.

The phrase 'expected to' in the definition of a liability

Issue summary

23. The comment letters indicate different views about the meaning of this phrase. Some understand 'expected to' to mean 'probable' (which they interpret as a threshold of 'more likely than not'). Accordingly, they argue that a prerequisite for the existence of a liability is a 'probable' outflow of economic benefits. Hence, a present obligation with a low or remote likelihood of an outflow of economic benefits would not satisfy the definition of a liability.

24. Others disagree and argue that the phrase 'expected to' is simply intended to convey that certainty about the outflow of economic benefits is not required to satisfy the definition of a liability. That is to say, the phrase 'expected to' means 'a more than 0% likelihood'. Proponents of this view argue that any present obligation that is capable of resulting in an outflow of economic benefits satisfies the definition of a liability.

Redeliberations

25. In the light of these differing views, the Board has clarified that the phrase 'expected to' does *not* require a particular degree of certainty about the outflow of economic benefits to exist before the definition of a liability is satisfied. The Board believes that its understanding is supported by:

(a) other parts of the *Framework* - for example, paragraph 50 emphasises that the degree of certainty that future outflows from the entity will occur is addressed in the *recognition* criterion, not in the definition of a liability.[8]

(b) considering 'expected to' in relation to common present obligations that are widely accepted as liabilities. Examples include written options, insurance contracts and product warranties: a *cash* outflow may not be required to satisfy the present obligation arising from a written option, insurance contract or a product warranty.

26. Again the Board emphasises that, if probability has a role in determining when the definition of a liability is satisfied, that role is limited to determining whether a present obligation exists (as noted in section A).

Question 3

(a) Do you agree that it is not necessary for a particular degree of certainty about the outflow of economic benefits to exist before the definition of a liability is satisfied? If not, why not?

(b) Do you agree that if probability has a role in determining when the definition of a liability is satisfied, that role is limited to determining whether a present obligation exists? If not, why not?

The probability recognition criterion

Issue summary

27. IAS 37 states that an entity should *recognise* a liability when it is probable (more likely than not) that an outflow of resources embodying economic benefits will be required to settle a liability.[9]

[8] *Framework*, paragraph 50: 'The definitions of an asset and a liability identify their essential features but do not attempt to specify the criteria that need to be met before they are recognised in the balance sheet …'

28. The ED proposes omitting this criterion. Many objected to this proposal because the IASB *Framework* specifically includes a probability recognition criterion. For example, paragraph 91 states that a liability is recognised only when 'it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation.'[10] Others objected to the proposal because they believe the criterion is a practical means of addressing uncertainty about the existence of a present obligation.

Redeliberations

29. The Board acknowledges that its proposal to omit the probability recognition criterion creates tension with the *Framework*. It has therefore reconsidered but tentatively affirmed its proposal. In the Board's view, there is no need for a separate probability recognition criterion in IAS 37 because any uncertainty about the amount or timing of the economic benefits required to settle a present obligation should be reflected in measurement, not recognition. This is because:

    (a) the *Framework* does not define 'probable'. Moreover, IAS 37 has established a unique interpretation of probability ('more likely than not').

    (b) other standards do not apply a probability recognition threshold. For example, IAS 39 *Financial Instruments: Recognition and Measurement* does not permit a writer of an option to delay the recognition of its obligation to deliver a commodity at a fixed price in the future until it is 'more likely than not' that the holder will exercise the option. Similarly, IAS 19 *Employee Benefits* does not permit an employer to delay the recognition of its obligation to provide long-term compensated absence to employees completing *x* years service until it is 'more likely than not' that an employee will complete *x* years service.[11]

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[9] IAS 37, paragraphs 14(b) and 23.
[10] See also *Framework* paragraph 83(a).
[11] In some jurisdictions this type of long-term compensated absence is known as 'long service leave'.

(c) a probability recognition criterion may result in inconsistent accounting for identical liabilities within the scope of IAS 37. For example, such a criterion would mean an entity would not recognise a liability arising from a single product warranty if it is 30 per cent likely that a fault is reported during the warranty period. But the same entity would recognise a liability if the entity had issued one hundred identical product warranties (even though it remains 30 per cent likely that a fault is reported for each individual product). This is because it is 'more likely than not' that at least one product will develop a fault during the warranty period.

(d) applying a probability recognition criterion creates tension with the measurement requirements in IAS 37 and might delay the reporting of useful information about items which satisfy the definition of a liability. For example, paragraphs 39 and 40 require an entity to consider all possible outcomes in the measurement of a liability, regardless of whether each possible outcome is 'more likely than not'.[12]

(e) a probability recognition criterion might detract from the first step in accounting for liabilities: does a liability exist on the balance sheet date?

Question 4

Do you agree that a probability recognition criterion has no role in the recognition of liabilities within the scope of IAS 37 (ie items that satisfy the definition of a liability)? If not, why not?

[12] IAS 37, paragraph 39 states that when the liability being measured involves a large population of items, the liability is measured 'by weighting *all possible outcomes* by their associated probabilities.' Paragraph 40 states that the individual most likely outcome may be the best estimate of a single liability but 'even in such a case, *the entity considers other possible outcomes*.' (emphasis added)

C. RELATED AMENDMENTS

30. As part of its redeliberations of issues associated with the recognition principle proposed in the ED the Board has also reconsidered its proposal to eliminate the term 'contingent liability' and introduce the notion of a stand ready obligation. This section summarises the outcome of these redeliberations.

Eliminating the term 'contingent liability'

Issue summary

31. IAS 37 uses 'contingent liability' to describe two different notions. The first notion is a *possible obligation*, arising when the existence of a present obligation is uncertain and will be confirmed only by a future event. The second notion is an *unrecognised present obligation*, ie a present obligation that is not recognised because the associated outflow of economic resources is not probable or cannot be measured reliably.[13]

32. The ED proposed eliminating the term 'contingent liability' because:

    (a) according to the *Framework*, only *present* obligations are liabilities. Therefore it is misleading to describe *possible* obligations as liabilities, (even with the modifier 'contingent').

    (b) describing unrecognised present obligations as contingent is contradictory. By definition, *present* obligations cannot be contingent on future events.

    (c) using the same term to describe two different notions is confusing.

[13] IAS 37, paragraph 10 defines a contingent liability as (a) a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or (b) a present obligation that arises from past events but is not recognised because (i) it is not probable that a an outflow of resources embodying economic benefits will be required to settle the obligation, or (ii) the amount of the obligation cannot be measured with sufficient reliability.

33. The comment letters indicate that many respondents share the Board's concerns about the term 'contingent liability'. But some disagree, arguing that the term is well understood and consistently applied in practice.

34. Some respondents agreed with the proposal to eliminate the term 'contingent liability'. Nonetheless, many of them were concerned that the ED's proposals might reduce the amount of useful disclosure about possible obligations, ie items that do not satisfy the definition of a liability but are currently subject to IAS 37 disclosure requirements for 'contingent liabilities'.

Redeliberations – eliminating the term 'contingent liability'

35. After considering the views expressed in the comment letters, the Board has tentatively affirmed its proposal to eliminate the term 'contingent liability' from IAS 37. In addition to the reasons outlined above, the Board noted that the term creates tension between IAS 37 and other standards. For example, a financial guarantee contract is classified as a liability in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*.[14] But if IAS 37 definitions were applied, the same contract would not be classified as a liability until it is probable that the debtor will fail to make payment when due. Similarly, an obligation arising from share appreciation rights is classified as a liability in accordance with IFRS 2 *Share-based Payment*.[15] But if IAS 37 definitions were applied, the same rights would not be classified as a liability until it is probable that the share price will increase to the specified price.

Redeliberations – reduced disclosure

36. In the light of concerns about reduced disclosure, the Board observed that the IAS 37 disclosure requirements for contingent liabilities that are possible obligations are narrower than suggested by some respondents. This is because they capture

[14] A contractual obligation to reimburse the holder for a loss incurred if a debtor fails to make payment when due.

[15] Rights granted to employees as part of their total remuneration whereby employees become entitled to future cash payments, rather than equity instruments, if the entity's share price increases to a specified level over a specified period of time

only *possible* obligations existing at the balance sheet date, rather than all business risks. Moreover, the Board emphasised that its proposal to eliminate the term 'contingent liability' was not intended to preclude useful disclosure about items that do not meet the definition of a liability. Rather, its intention is to emphasise that IAS 37 is a standard about liabilities. Therefore, disclosure requirements for items that do not meet the definition of a liability do not belong in IAS 37.

37. The Basis for Conclusions accompanying the ED notes that IAS 1 *Presentation of Financial Statements* already requires management to disclose significant judgements made in the process of applying an entity's accounting policies.[16] However, the Board has acknowledged that IAS 1 may not capture all items regarded as possible obligations and disclosed in accordance with IAS 37.

38. The Board discussed the possibility of developing a disclosure principle that would allow users to evaluate an entity's determination of whether the definition of a liability is satisfied when there is uncertainty about the existence of a present obligation. However, the Board was concerned that such a principle would be impracticable. Therefore, during 2007 the Board intends to consider more specific disclosure requirements (for example, to capture asserted legal claims for which the entity concludes it has no present obligation).

Stand ready obligations

Issue summary

39. The ED introduced the term 'stand ready obligation' and explained that 'liabilities for which the amount that will be required in settlement is contingent on the occurrence or non-occurrence of a future event are sometimes referred to as 'stand ready' obligations. This is because the entity has an unconditional obligation to stand ready to fulfil the conditional obligation *if* the future event occurs (or fails to

[16] IAS 1, paragraphs 113 and 116.

occur). The liability is the unconditional obligation to provide a service, which results in an outflow of economic benefits.'[17]

40. The comment letters indicate general agreement that the notion of a stand ready obligation can be applied to contractual obligations. But many are concerned that the ED's explanation is too wide for non-contractual obligations. This may result in a limitless number of non-contractual items being recognised as liabilities, including items often regarded as business risks.

Redeliberations

41. In the light of these comments, the Board has emphasised that an item must first satisfy the definition of a liability, ie a present obligation must exist. The term 'stand ready' is then used to describe liabilities for which the outflow of economic benefits is a service provided from inception, regardless of the occurrence (or non-occurrence) of a future event.

42. The Board has also decided to expand the explanation of a stand ready obligation to ensure that the distinction between a stand ready obligation and a business risk is clear. The Board has started to address this issue by analysing a series of non-contractual examples. The Board plans to continue its discussions on this issue in 2007.

[17] ED, paragraph 24.

D. MEASUREMENT

Principle

43. The proposed measurement principle underpinning the ED is: An entity shall measure a 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. Part (b) of the proposed recognition principle underpinning the ED is: An entity shall recognise a liability when the liability can be measured reliably. This section considers issues associated with both principles.

Scope of proposed amendments to the existing measurement principle

Issue summary

44. The existing IAS 37 measurement principle is: The amount recognised as a provision shall be the best estimate of the expenditure required to settle the present obligation at the balance sheet date.[18] The ED explained that the Board decided to amend this principle because the notion of ‘best estimate of the expenditure required to settle’ is unclear and may be interpreted in different ways. But the Board decided not to identify and evaluate all possible measurement principles for IAS 37 as part of this project in view of the comprehensive review of measurement being performed as part of its conceptual framework project.

45. The ED therefore proposed limited amendments to the existing measurement principle – namely, to emphasise that the existing measurement principle is based on a current settlement notion, and to clarify aspects of the accompanying guidance. In particular, the ED proposed using an expected cash flow approach to estimate all liabilities within the scope of IAS 37, including single obligations.[19]

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[18] IAS 37, paragraph 36.

[19] In this paper the term ‘expected cash flow approach’ is used as shorthand for probability-weighted cash flows, discounted to present value and adjusted to reflect the risks and uncertainties associated with the liability.

46. The comment letters indicate that many respondents perceive the impact of the proposed amendments to be greater than the Board intended. In particular, several argued that the ED implicitly proposes to establish fair value as the measurement principle for liabilities within the scope of IAS 37 – an outcome most would not support. Others question the need to make any amendment at this time.

Redeliberations

47. The Board has tentatively affirmed its decision to make limited amendments to the IAS 37 measurement principle. The Board noted that the comment letters supported its view (explained in the ED) that 'best estimate of the expenditure required to settle' is not a clear measurement principle and has caused divergence in practice. Whilst acknowledging similarities between the IAS 37 measurement requirements and fair value, the Board also decided against labelling the proposed measurement principle 'fair value' as part of this project.

The measurement principle

Issue summary

48. The proposed measurement principle is derived from the explanation of 'best estimate of the expenditure required to settle' in paragraph 37 of IAS 37. The Board therefore regarded the proposed principle as clarifying (rather than changing) the existing measurement principle. The existing principle is already based on a current settlement notion - the amount an entity would pay to settle the liability *on the balance sheet date* (either by settling its obligation with the counterparty or transferring the obligation to a third party).

49. However, the comment letters indicate that many do not share the Board's understanding of the existing measurement principle. Those respondents understand the existing measurement principle to be an ultimate settlement notion – ie to depict the cash outflow that an entity expects to incur to settle a present obligation *in the future*.

50. For example, in the case of a warranty, some respondents argue that the existing measurement principle requires an estimate of the amount it would cost an entity to repair or replace a faulty product within the remaining warranty period. In other words, the individual most likely cash outflow the entity expects to incur in the future, discounted to present value. But the Board believes that the existing measurement principle requires an estimate of the entity's obligation under a product warranty *today*, taking into account the likelihood that a faulty product will be reported within the remaining warranty period.

51. Moreover, the comment letters indicate that some respondents believe that the proposed measurement principle permits choice. They believe there is a difference between the 'amount to settle' and the 'amount to transfer' a present obligation on the balance sheet date.

Redeliberations

52. In the light of the comments received, the Board has re-examined the IAS 37 measurement principle. The Board acknowledges that the wording of the principle and accompanying guidance is not always clear. Nonetheless, the Board has tentatively affirmed its belief that the existing measurement principle is based on a current settlement notion. This is because:

    (a) the phrase 'at the balance sheet date' in the principle clarifies that an entity's 'best estimate of the expenditure required to settle' is the amount it would pay to settle a present obligation *on that date*, not in the future.

    (b) paragraph 37 of IAS 37 acknowledges that it will often be impossible or prohibitively expensive for an entity to settle or transfer a present obligation *at the balance sheet date*. Nevertheless, paragraph 37 explains that an estimate of that amount represents the amount an entity would rationally pay to settle or transfer an obligation on the balance sheet date.[20]

[20] Paragraph 37 is consistent with the additional explanation of 'best estimate' provided in appendix VII of FRS 12 (the UK equivalent of IAS 37). Paragraph 22 states: 'it will often be impossible or prohibitively

(c) the guidance in paragraphs 37-50 of IAS 37 is generally consistent with a current settlement notion. For example, paragraph 47 states that an entity should select a discount rate that reflects *current market assessments* of the time value of money.

53. Moreover, the Board's understanding accords with the explanation of 'best estimate' used by other standard-setters in standards based on IAS 37. For example, the Australian equivalent of IAS 37 describes 'best estimate' as the amount an entity would rationally pay on the balance sheet date to 'settle directly the present obligation *immediately* or to provide consideration to a third party to assume it'.[21] The Board's understanding also accords with analyses of IAS 37 completed independently of the IASB and this project. For example, whilst not agreeing with the IAS 37 measurement principle, an analysis prepared by an international accounting firm states 'it is interesting that a hypothetical transaction of this kind should be proposed as the conceptual basis of the measurement requirement, *rather than putting the main emphasis upon the actual expenditure that is expected to be incurred in the future*.'[22]

54. The Board has also reconsidered the wording of the measurement principle proposed in the ED. The Board acknowledges that using two phrases ('amount to settle' and 'amount to transfer') to express the principle is confusing. The Board has therefore tentatively decided to remove one of the phrases from the measurement principle in any new Standard.

55. The Board has noted that 'amount to settle' is broader than 'amount to transfer' and may be interpreted in different ways. Moreover, the counterparty might demand more than the rational economic value of a liability to 'settle' the liability on the balance sheet date. However, the Board was concerned that retaining only 'amount to transfer' might imply that it was specifying fair value as the IAS 37 measurement objective – a decision that is beyond the scope of this project.

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expensive to settle or transfer an obligation at the balance sheet date … However, a provision should, in principle, be recognised at the amount of the obligation that existed at the balance sheet date'.

[21] AASB 1044 (amended 2001), paragraph 8.1.1 (emphasis added).

[22] *International GAAP 2005,* Global Edition 1, chapter 25, section 4.1(emphasis added).

56. The Board has not yet concluded its redeliberations on this issue. It intends to develop an example illustrating how an entity should measure a liability using the following draft guidelines:

- The proposed measurement principle is 'the amount an entity would rationally pay to settle an obligation on the balance sheet date' – a current settlement notion. An entity may settle a liability on the balance sheet date in one of two ways: paying the counterparty to release the entity from its obligation or paying a third party to assume its obligation.

- An entity should give precedence to market information when available. In the absence of market information, entity-specific information is consistent with the measurement principle provided there is no indication that it is inconsistent with the information the market would use.

Question 5

Do you agree that the proposed measurement principle is derived from the explanation of 'best estimate of the expenditure required to settle' in paragraph 37 of IAS 37? Do you agree that the existing principle is based on a current settlement notion? If so, how would you characterise a current settlement notion? If not, how would you characterise the existing IAS 37 measurement principle?

Useful information about liabilities within the scope of IAS 37

Issue summary

57. The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions.[23] The comment letters indicate that many are not confident that a measurement principle based on a current settlement notion (estimated by applying an expected cash flow approach

[23] *Framework*, paragraph 12.

to all liabilities within the scope of IAS 37) will provide useful information. Common concerns expressed in the comment letters are:

(a) markets do not exist for many liabilities within the scope of IAS 37. Measuring a liability based on a hypothetical transaction fails to reflect economic reality, and therefore is irrelevant for users of financial statements.

(b) the absence of a market increases reliance on subjective estimates. Estimates decrease the reliability, comparability and verifiability of financial statements and increase the risk of inappropriate earnings management.

(c) measurement based on a current settlement notion is likely to increase volatility in profit or loss. It would therefore be more difficult for users to understand an entity's financial performance and compare its financial performance from one period to the next.

(d) a wide range of possible outcomes may exist for single obligations and present obligations with a low probability of an outflow of economic resources. An estimate based on a current settlement notion is unlikely to equal any of the future possible outcomes, and therefore does not provide useful information to users.

(e) complex models may be needed to measure liabilities within the scope of IAS 37. The cost of developing these models might outweigh the benefit of additional information provided.

58. Several respondents argued that a measurement principle based on an estimate of the cash outflow required to settle a liability (estimated using the individual most likely outcome) would provide more useful information about liabilities within the scope of IAS 37.

Redeliberations

59. The Board has evaluated the relative merits of both a measurement principle based on a current settlement notion and a measurement principle based on an estimate of the cash flow required to settle a liability (the individual most likely outcome) using the attributes of useful information described in the *Framework* (qualitative characteristics). Appendix A summarises the outcome of this evaluation.

60. Both measurement principles provide useful information about liabilities within the scope of IAS 37. But on the basis of this evaluation, the Board has tentatively affirmed its preference for a measurement based on a current settlement notion (estimated by applying an expected cash flow approach to measure all liabilities within the scope of IAS 37, including single obligations). In reaching this conclusion, the Board particularly emphasised that:

- many equate reliability with the proximity of the measure of a liability on the balance sheet date to the actual cash flow required to settle the liability. But a difference between the measure of a liability on the balance sheet date and the actual cash flow required to settle a liability does not necessarily mean that the measure was 'wrong'.

- 'reliable measurement' refers to the reliability of the inputs used to estimate a liability and application of the chosen estimation technique.

- a current settlement notion (estimated by applying an expected cash flow approach) incorporates in the estimate of a liability all information about a liability that is available on the balance sheet date. In contrast, a measurement principle based on an estimate of the cash outflow required to settle a liability (the individual most likely outcome) ignores some information about a liability that is available on the balance sheet date.

- the subjectivity required to measure a liability based on a current settlement notion is no greater than the subjectivity required to estimate the individual most likely cash flow required to settle a liability. An estimate of the individual most likely cash flow required to settle a liability (ie the cheque the entity expects to write) requires speculation about future events for which no objective evidence exists on the balance sheet date (for example, technological advances or changes in the law). An estimate based on a current settlement notion is also subjective, but is based on objective evidence that exists on the balance sheet date.

61. The Board also intends to consider the extent of disclosure needed to assist users in understanding liabilities measured using subjective estimates. This work is ongoing. The Board plans to consider this point in 2007 (in conjunction with other issues associated with the disclosures proposed in the ED).

Question 6

Do you agree that a measurement principle based on a current settlement notion (estimated by applying an expected cash flow approach) would provide more useful information about liabilities within the scope of IAS 37 than a measurement principle based on an estimate of the cash outflow (estimated using the individual likely outcome)? If not, why not?

Guidance on how to apply the proposed measurement principle

Issue summary

62. The ED explains that expected value should be used in measuring all liabilities within the scope of IAS 37. The existing standard provides high level guidance on the core components of an expected value calculation: probability-weighted cash flows, discount rates and risk adjustments. This guidance has been carried forward to the ED largely unchanged. (Some editorial amendments were made to

improve the clarity of explanation and an example was added to the illustrative examples accompanying the ED.)

63. The comment letters indicate that many are concerned that it is not possible to apply the proposed measurement principle in practice (even if they agree that a measurement principle based on a current settlement notion would provide useful information about liabilities within the scope of IAS 37). As a result, many items that satisfy the definition of a liability would not be recognised because they cannot be measured reliably.

Redeliberations

64. The Board has tentatively decided that a new Standard should include additional guidance on how to apply the proposed measurement principle to liabilities within the scope of IAS 37. Appendix B lists the topics the Board intends to address in such a Standard.

65. The additional guidance is work in progress. However, the Board has instructed the staff to focus on explaining the attributes of information required to apply the proposed measurement principle. The Board does not intend to provide detailed application guidance on measuring liabilities within the scope of IAS 37. This is because:

    (a) the potential sources of information and type of model required to apply the proposed measurement principle will differ depending on the nature of the liability.

    (b) it is not feasible for the Board to provide detailed guidance for all liabilities within the scope of IAS 37 in all jurisdictions. Different legal environments may require the use of different information to measure similar liabilities.

    (c) detailed guidance may become outdated and could prevent an entity using improved estimation techniques that become available in the future.

(d) detailed guidance may become a list of rules. Explaining the attributes of an estimate developed using expected value is consistent with a principle-based approach to standard-setting.

(e) detailed guidance is not required to meet the needs of the majority of standard-readers and may obscure important information.

Question 7

Do you expect to encounter difficulties in applying the proposed measurement principle? If so, in what circumstances and why? How could these difficulties be overcome? Do these difficulties have any implications for disclosure requirements?

E. OTHER AMENDMENTS PROPOSED IN THE ED

Proposed amendments redeliberated by the Board

66. This section provides a brief summary of the tentative conclusions reached during the Board's redeliberation of other amendments proposed in the ED.

Project objectives

67. The Board has tentatively affirmed the project objectives, namely: (a) to analyse some items currently described as contingent assets and contingent liabilities in terms of assets and liabilities as defined in the *Framework*; and (b) to bring the application guidance for accounting for costs associated with restructurings in IAS 37 into convergence with the requirements of SFAS 146 *Accounting for Costs Associated with Exit or Disposal Activities*.

68. Most respondents supported objective (b) because they see it as progress towards removing the reconciliation requirement for non-US companies registered in the US that use IFRSs. But some were concerned that objective (a) would create divergence between IAS 37 and SFAS 5 *Accounting for Contingencies*, impeding progress towards convergence. They question why the IASB has not considered the proposals jointly with the FASB.

69. However, the Board has concluded that IAS 37 and SFAS 5 are already different standards. SFAS 5 is not based on the definition of a liability—it was issued in 1975, five years before the FASB concepts statements defined a liability.[24] The International Accounting Standards Committee (IASC) departed from the SFAS 5 approach when it replaced IAS 10 with IAS 37 in 1998. This conclusion was also the view of the FASB staff in 1999 when they compared US GAAP and international standards in *The IASC-US Comparison Project: A Report on the Similarities and Differences between IASC Standards and US GAAP*.

[24] The current US GAAP definition of a liability was first introduced in FASB Concepts Statement No. 3 *Elements of Financial Statements of Business Enterprises* in 1980. Concepts Statement No. 3 was superseded by FASB Concepts Statement No. 6 *Elements of Financial Statements* in 1985.

70. The view that the ED increases divergence from US GAAP also fails to acknowledge that its approach is consistent with more recent US GAAP pronouncements on liabilities.[25] Like IAS 37, those pronouncements focus on *liability* recognition and measurement, consistently with the FASB concept statements, rather than the notion of loss recognition.[26] Hence, the more recent FASB pronouncements are themselves very different from the approach in SFAS 5.

Scope of IAS 37

71. The ED proposed that IAS 37, except in specified cases, should be applied in accounting for all liabilities that are not within the scope of other standards. Many respondents view this proposal as an extension of scope that establishes IAS 37 as a default or 'catch all' standard for liabilities. Therefore, the Board reconsidered whether the requirements proposed in the ED are appropriate for all liabilities not within the scope of other standards.

72. In reconsidering this proposal, the Board confirmed that its intention was to establish IAS 37 as a general standard for liabilities (other than liabilities covered by other standards, such as financial instruments or employee benefits). It also noted it had asked respondents to supply examples of liabilities for which the requirements of the ED would be inappropriate and none had been provided. Accordingly, the Board tentatively affirmed that IAS 37, except in specified cases, should be applied for all liabilities that are not within the scope of other standards.

73. Nonetheless, the Board noted that the proposed scope had caused some confusion. For example, some respondents were concerned about the relationship between IAS 18 *Revenue* and IAS 37. Consequently, the Board expects to modify the

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[25] For example, FAS 143 *Accounting for Asset Retirement Obligations* and its related Interpretation FIN 47 *Accounting for Conditional Asset Retirement Obligations,* and FIN 45 *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others.*

[26] This approach is confirmed in the summary of FIN 45 which states 'the guarantor's recognition of a liability at the inception of a guarantee for the obligation it has undertaken in issuing the guarantee is consistent with the definition of a liability in FASB Concepts Statement No.6 …'

scope to clarify that performance obligations measured in accordance with IAS 18 on the basis of consideration received (ie deferred revenue) would not be within the scope of IAS 37 unless the contract was onerous.

Recognition of liabilities that are the subject of litigation

74. The Board has considered respondents' concerns that recognising a liability can prejudice an entity's position in litigation. However, the Board tentatively concluded that it would not be possible to accommodate concerns about the operation of different legal jurisdictions in one standard. Furthermore, any such accommodation would compromise the usefulness of information provided in the financial statements. The ED proposed retaining the existing prejudicial disclosure exemption (paragraph 92 of IAS 37) and the Board has concluded tentatively that no further exemptions are required.

Proposed amendments not yet redeliberated by the Board

75. The Board plans to redeliberate issues associated with the following proposed amendments in 2007:

- disclosure requirements
- contingent assets, including reimbursement rights
- short-term convergence (including constructive obligations, onerous contracts, restructuring costs and termination benefits)

76. The introduction to the ED provides a summary of the proposed amendments to each topic. A summary of the issues raised in the comment letters is available on the IASB Website.[27]

[27] A copy of the ED is available on the IASB Website:
http://www.iasb.org/NR/rdonlyres/1CFBC1A8-50F1-4BF3-9A33-579F849560C8/0/EDAmendstoIAS37.pdf
A copy of the comment letter summary is also available: http://www.iasb.org/NR/rdonlyres/69877304-54A9-44B4-AADF-9BE2E32B5C45/0/0602CommentLetterSummaryAppendix.pdf

APPENDIX A: EVALUATION OF MEASUREMENT PRINCIPLES FOR LIABILITIES WITHIN THE SCOPE OF IAS 37

A1. This appendix uses a lawsuit as an example of a liability to evaluate the relative merits of a measurement principle based on a current settlement notion (estimated using an expected cash flow approach) and a measurement principle based on an estimate of the cash outflow required to settle a liability (using the individual most likely outcome).

A2. The fact pattern in this example is acknowledged to be simplistic compared with the fact pattern in a 'real' lawsuit. This example ignores the time value of money and any risk inherent in the liability itself. However, the Board considered that a more complex fact pattern might detract from an evaluation of the two measurement principles.

FACT PATTERN

A3. Entity X is being sued (is the subject of a lawsuit). Entity X agrees that its past actions violated a law and that the law requires Entity X to pay compensation to the plaintiff for damages caused by Entity X's past actions. In other words, it is certain that the definition of a liability is satisfied. However, Entity X disputes the amount of compensation demanded by the plaintiff for damages caused by Entity X's past actions.

A4. On the basis of legal advice, as at 31 December 20X0 Entity X estimates that it is 5 per cent likely that the court will order Entity X to pay CU100 million to the plaintiff (the amount demanded by the plaintiff), 90 per cent likely that the court will order Entity X to pay CU40 million to the plaintiff; and 5 per cent likely that the court will order Entity X to pay CU20 million to the plaintiff.[28] There are no other possible cash outflows.

[28] CU = currency units

A5. During the half-year ended 30 June 20X1 new information about the lawsuit becomes available which is favourable to Entity X. On the basis of legal advice, Entity X now estimates that it is 55 per cent likely that the court will order Entity X to pay CU40 million to the plaintiff; and 45 per cent likely that the court will order Entity X to pay CU20 million to the plaintiff.

EVALUATION

Estimate	**Current settlement notion (estimated by applying an expected cash flow approach)**[29]	**Cash outflow required to settle a liability (using the individual most likely outcome)**
31 December 20X0	CU42 million	CU40 million
30 June 20X1	CU31 million	CU40 million

Qualitative characteristic	**Current settlement notion (estimated using an expected cash flow approach)**	**Cash outflow required to settle a liability (using the individual most likely outcome)**
Relevance (*Framework*, 26-28)	Reflects information about all possible outflows and the change in management's estimate due to new information about the liability becoming available during the period ended 30 June 20X1. This information could be capable of making a difference to users in their decision making. Does not reflect management's estimate of the individual most likely cash outflow required to settle the lawsuit.	Reflects management's estimate of the most likely cash outflow required to settle the lawsuit. Does not reflect information about other possible cash outflows or the change in management's estimate due to new information about the liability becoming available during the period ended 30 June 20X1.
Faithful representation - necessary to achieve reliability (*Framework*, 33-34)	The decrease in Entity X's liability on 30 June 20X1 reflects the effect of known events that occurred during the period.	Entity X's liability remains unchanged on 30 June 20X1. It does not reflect the effect on management's estimate of known events that occurred during the period.

[29] 5% of CU100m + 90% of CU40m + 5% of CU20m = CU42m
55% of CU40m + 45% of CU20m = CU31m

Qualitative characteristic	**Current settlement notion (estimated using an expected cash flow approach)**	**Cash outflow required to settle a liability (using the individual most likely outcome)**
Substance over form – necessary to achieve reliability (*Framework*, 35)	Not applicable to this example.	Not applicable to this example.
Neutrality - necessary to achieve reliability	Uses independent legal advice to apply an expected cash flow approach. Management's estimate can be verified by reference to this legal advice.	Uses independent legal advice to estimate the most likely cash outflow required to settle the obligation. Management's estimate can be verified by reference to this legal advice.
Prudence – necessary to achieve reliability (*Framework*, 37)	Incorporates the worst possible outcome. But does not overstate Entity X's liability at either balance sheet date because management's estimate also incorporates the best possible outcome and the most likely outcome of the lawsuit.	Considers all possible outcomes (including the worst possible outcome) but does not reflect the worst possible outcome in the liability recognised by Entity X on both balance sheet dates.
Completeness - necessary to achieve reliability (*Framework*, 38)	Reflects information about all possible cash outflows at both balance sheet dates.	Considers all possible outcomes but reflects information about only one possible cash flow at both balance sheet dates.
Comparability (*Framework*, 39-42)	The decrease in the estimate of Entity X's liability on 30 June 20X1 reflects the change in management's estimate of the financial position of Entity X from one period to the next.	Entity X's estimate of its liability remains unchanged. This suggests that management believes Entity X is in the same financial position on both balance sheet dates.
Understandability (*Framework*, 25)	Users may require additional information to understand the estimation technique applied by Entity X and the uncertainties associated with management's estimate of the liability on both balance sheet dates.	Users may require additional information to understand the estimation technique applied by Entity X and the uncertainties associated with management's estimate of the liability on both balance sheet dates.

A6. The evaluation above illustrates that both measurement principles provide useful information about Entity X's liability (although sometimes the measurement principles meet the qualitative characteristics in the *Framework* for different reasons). However, on balance, the Board believes that a measurement principle

based on a current settlement notion provides superior information about Entity X's liability because an expected cash flow approach is capable of reflecting changes in facts and circumstances relating to the liability on a timely basis.

APPENDIX B: ADDITIONAL MEASUREMENT GUIDANCE

B1. Topics the Board intends to address in the measurement guidance included in a new Standard:

- The complexity of the model required to complete an expected value calculation will vary depending on the nature of the liability being measured.
- An entity should give precedence to market information when available. In the absence of market information, entity-specific information is consistent with the measurement principle.
- The objective and attributes of a risk adjustment.
- Risks specific to a liability may be reflected in either the probability-weighted cash flows or the discount rate.
- An estimate of a liability should reflect the credit risk of the liability.

B2. The Board has also decided to reconsider the following questions as part of its redeliberations and provide more guidance if appropriate:

- Is a possible change in law that affects a liability a future event that should be reflected in the measurement of a liability, or is it a future event that will create a new liability or extinguish part or all of an existing liability?
- Should an entity's estimate include expenses directly attributable to the settlement of that liability, for example the costs of defence?
- What are the 'rare circumstances' in which a liability may not be capable of reliable measurement? Are exceptions required?