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International
Accounting Standards
Board

IAS 37 Round-table Discussions: Summary of outcomes

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This document summarises comments made by participants at the IAS 37 round-table discussions in Norwalk, London and Melbourne in November and December 2006. The format of the round-table discussions did not permit Board members to explore each of the comments in detail. Consequently, Board members and participants may not have a common understanding of the views expressed. The Board will consider participants' comments in more detail and, where appropriate, seek to clarify those comments as part of its on-going redeliberations on the proposed amendments to IAS 37 and before reaching any conclusions.

INTRODUCTION

1. This paper summarises views expressed by participants at the IAS 37 round-table discussions on the Board's tentative conclusions reached after redeliberating issues associated with the liability recognition and measurement principles proposed in the Exposure Draft of Proposed Amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and IAS 19 *Employee Benefits* (ED). The paper should be read in conjunction with the background materials distributed prior to the round-table discussions. Audio playbacks of each round-table discussion are also available on the IASB's external website.¹

¹ Both the background materials and the audio tapes can be accessed via the IAS 37 round-tables web page: <http://www.iasb.org/Current+Projects/IASB+Projects/Liabilities/Round-table+discussions/Round-table+discussions.htm>

2. The paper begins with the general comments received on this project and the Board's approach to redeliberations. It then summarises participants' views on each of the discussion questions posed in the background materials.

GENERAL COMMENTS

Project objectives

No reason to change

3. Several participants, especially in London and Melbourne, questioned the Board's decision to amend IAS 37 at this time. They asked the Board to explain why this project is precedential and what information is currently missing from financial statements (either in the balance sheet or in the notes to the financial statements) to justify such significant changes.
4. Many participants argued that, although IAS 37 is not perfect, there are no pervasive problems in the standard that require immediate attention. They opposed prioritising amendments to IAS 37 over what they perceive to be more urgent issues, such as revenue recognition and developing guidance for the insurance and extractive industries. One participant noted that the pace of change may mean that unnecessary amendments to existing standards are misunderstood and misapplied in practice.
5. Other participants noted that the Board's proposals will increase differences between IAS 37 and SFAS 5 *Accounting for Contingencies*. This outcome creates tension with the priority given to convergence with US GAAP in the Memorandum of Understanding.

Resolving inconsistency with other standards

6. Many participants did not find inconsistency in the accounting for contingencies in IAS 37 and the accounting for contingencies in a business combination (the starting point for this project) sufficient compelling to justify amending IAS 37. They noted that other standards differentiate between acquired and internally

generated assets and liabilities, such as IAS 38 *Intangible Assets*, and noted that the Board is not attempting to resolve these inconsistencies.

7. Similarly, many participants did not agree that inconsistencies in the recognition of liabilities within the scope of IAS 37 and the recognition of liabilities within the scope of other standards justifies amending IAS 37. Further observations on this point are included in paragraphs 41-43 below.

Overall approach

8. Despite concerns about amending IAS 37 at this time, many participants agreed that uncertainty is an important issue that warrants debate and that the Board's proposals have some conceptual merit. They therefore suggested using the thinking developed in this project (together with constituents' feedback) to progress other projects such as the conceptual framework, revenue recognition and insurance. These participants argued that this approach would provide the Board with an opportunity to:
 - discuss these important issues with the FASB and develop joint guidance;
 - consider the effect of the Board's proposals on all liabilities, not only those within the scope of IAS 37; and
 - seek additional feedback from constituents (given that most related projects are at the discussion paper stage).
9. For example, some participants suggested that the Board limit the scope of this project to moving product warranties for which no separately identifiable consideration is received into IAS 18 *Revenue* (leaving all other aspects of IAS 37 unchanged).
10. One participant also asked the Board to consider the effect of its proposals on public bodies that have liabilities with a low probability of high payoff. Another

asked whether there are any links between this project and recent discussions on uncertain tax positions.

THE RECOGNITION PRINCIPLE

The Board's approach to redeliberating the definition of a liability

11. The recognition principle underpinning the IAS 37 ED is 'an entity shall recognise all items that (a) satisfy the definition of a liability on the balance sheet date, and (b) can be measured reliably'. As explained in the background materials, the Board's redeliberations in 2006 focused on two different aspects of the definition of a liability: (i) uncertainty about the existence of a present obligation; and (ii) uncertainty about the outflow of economic benefits associated with a present obligation. Discussion questions 1-3 of the background materials distributed prior to the round-tables reflected this approach.
12. Some participants did not find the Board's approach useful. They noted that non-recurring single transactions or events are the most problematic and suggested that, in these circumstances, separating uncertainty about the existence of a present obligation from uncertainty about the outflow of economic benefits is not helpful. These participants suggested that addressing uncertainty as a whole would be more useful than the Board's approach. As a result they were reluctant to answer questions 1-3 individually.
13. Nevertheless, most of these participants supported the Board's intention to clarify the boundary between a liability and a business risk. Several considered clarifying when a past event(s) gives rise to a present obligation to be critical.

EXISTENCE OF A PRESENT OBLIGATION

Uncertainty about the existence of a present obligation

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?

The need for additional guidance

14. Most participants supported the Board's intention to provide additional guidance on this issue. But a small number argued that no standard can provide guidance on how to exercise judgement and therefore that neither approach suggested in the background materials would resolve this issue.
15. Others preferred not to express a view on either approach suggested in the background materials. For some this was because they perceived no difference between the two alternatives: both require management to exercise judgement and the Board has simply expressed that fact in two different ways. Others preferred to reserve their comments until Board produces draft indicators.

Indicators

16. Some participants agreed with question 1. (Although several emphasised that indicators should supplement, not replace, the requirement to evaluate all available evidence in paragraph 16 in the ED.) They argued that any threshold inappropriately implies that, at a specific point, it is certain that a transaction or event satisfies the definition of a liability. Also, some participants were concerned that a threshold might cause entities to dismiss some items that are present obligations on the balance sheet date.

17. At the same time, many acknowledged the challenge of drafting indicators capable of international application by all industries. For this reason, most favoured high-level indicators, like those suggested in paragraph 14 of the background material. A small number of participants in Melbourne favoured industry-specific indicators.
18. Participants cited the appendix to SIC-12 *Consolidation – Special Purpose Entities* and paragraph 12 of IAS 36 *Impairment of Assets* as good examples of indicators in other standards because they reflect economic reality. Other suggested indicators include: post balance sheet events, the start of legal proceedings, detection or a past history of detection (see question 2) and, in some circumstances, cash outflows. One participant suggested also clarifying which facts and circumstances are *not* indicators, such as management intent.

A ‘more likely than not’ threshold

19. Other participants, especially in London, favoured re-instating a ‘more likely than not’ threshold to help an entity determine whether a present obligation exists on the balance sheet date. They argued that, compared to indicators, a ‘more likely than not’ threshold:
- (a) promotes consistent application by providing a clear benchmark;
 - (b) can be applied internationally because it is industry-neutral; and
 - (c) allows management to weight all available evidence and exercise judgement in determining whether a present obligation exists on the balance sheet date. In contrast, indicators might be perceived as rules and inappropriately used to override management judgement when it is most needed.
20. Proponents of a ‘more likely than not’ threshold also noted that there is often more uncertainty associated with liabilities within the scope of IAS 37 compared to liabilities within the scope of other standards. Although a conceptual

compromise, these participants argued that a ‘more likely than not’ threshold is needed as a practical expedient in IAS 37.

Constructive obligations

21. Some participants were concerned that the background material focused on legal obligations only. They urged that Board to consider constructive obligations as part of their redeliberations on this topic.

Lawsuits

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?

General comments on lawsuits

22. Most participants agreed that lawsuits are particularly problematic in the context of this project because they often combine uncertainty about the existence of a present obligation and uncertainty about the outflow of economic benefits. They also noted that there are sensitivities associated with lawsuits not associated with most other liabilities within the scope of IAS 37. This means that disclosures about lawsuits (regardless of whether a lawsuit satisfies the definition of a liability) are limited. No participant favoured removing the prejudicial disclosure exemption from the ED.
23. In Norwalk, one Board member asked if taking lawsuits out of the equation, either through excluding lawsuits from the scope of IAS 37 or through an exception to

the proposed recognition and/or measurement principles, would be useful. Most participants indicated that this approach merits consideration.

Start of legal proceedings

24. Most participants in London and Melbourne agreed with question 2(a). But views in Norwalk were mixed. Some participants argued that an entity is obliged to defend itself against all lawsuits, and therefore at the start of legal proceedings an entity should at least recognise a liability for legal costs. But other participants argued that an obligation to incur legal costs in the future does not satisfy the definition of a liability on the balance sheet date. In Norwalk, participants also discussed whether the start of legal proceedings indicates a potential asset impairment, rather than giving rise to a potential obligation. Participants did not reach a consensus but, as a minimum, they agreed that the start of legal proceedings indicates that an entity needs to *consider* whether a present obligation exists (ie the start of legal proceedings could be an indicator for determining whether there is a present obligation).
25. Most participants agreed that a present obligation can exist before an adverse court ruling. They emphasised that an entity should continuously review the facts and circumstances of ongoing legal proceedings to determine whether a present obligation exists at each balance sheet date.

External detection

26. Participants' views on question 2(b) were mixed. Many agreed that a present obligation can exist before the start of legal proceedings, but with reservations.
27. Several participants emphasised that knowledge of a breach of contract or violation of a law may give rise to a present obligation, but it does not mean that the definition of a liability is satisfied. They argued that linking the existence of a present obligation with an outflow of economic benefits is critical. That is to say, a present obligation might exist, but without detection (and an expected outflow of economic benefits) the definition of a liability is not satisfied. Illustrating this

- point, several participants gave the example of a driver who knowingly exceeds the speed limit without detection and therefore does not expect to receive a fine.
28. Other participants considered the Board's tentative conclusion impractical. They questioned how far companies and auditors would need to investigate before satisfying themselves that they do not 'know' a present obligation exists. Some argued that the conclusion in question 2(b) could penalise entities with good internal controls and reporting systems. A few participants also questioned the relevance of knowledge in a principle-based standard. These participants argued that a present obligation only exists as a result of a past event – a matter of fact – therefore knowledge has no place in a principle.
29. In Melbourne, several participants disagreed with question 2(b). They argued that detection, or a past history of detection, is an indicator an entity should use to determine whether a present obligation exists. One participant also pointed out that the other party cannot recognise an asset before detecting a breach of contract or violation of the law.
30. Participants in London acknowledged that objecting to question 2(b) could create inconsistency between the accounting for a breach of a contract or a violation of a law in IAS 37 and in a business combination. This is because due diligence means that an acquirer typically has access to more information than users of financial statements and therefore this places the acquirer in a better position to assess the entity's (the acquiree's) own assessment about the existence of a present obligation. However, these participants did not believe consistency with a business combination was sufficiently compelling to override the reservations noted above. Moreover, several commented that a specific amount is rarely attributed to lawsuits in purchase price negotiations. If the risk associated with a particular lawsuit is considered sufficiently large, the purchase price agreement will typically include some form of protection for the acquirer (for example, an indemnity clause or contingent consideration) or the acquisition will not proceed.

UNCERTAINTY ABOUT AN OUTFLOW OF ECONOMIC BENEFITS

The phrase ‘expected to’ in the definition of a liability

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?

31. Participants’ views on question 3 were mixed and often linked to question 4 (see below). In Melbourne and London, a majority favoured requiring some degree of certainty about an outflow of economic benefits before an item is recognised as a liability, either as part of the definition of a liability or as a separate recognition criterion. In Norwalk, views were mixed. Most users, insurance and actuarial representatives agreed with both questions 3 and 4, whereas most non-insurance preparers and auditors disagreed.

No degree of certainty is required

32. Many participants agreed with question 3 for the reasons outlined in paragraph 29 of the background material. However, several noted that the phrase ‘expected to’ is open to misinterpretation and needs reconsidering as part of the in the conceptual framework project. Some of these participants went on to disagree with the proposal to omit the probability recognition criterion from IAS 37 (question 4 below).

A degree of certainty is required

33. Other participants disagreed with question 3 because common usage of the phrase ‘expected to’ implies a particular degree of certainty, typically greater than 50%.

Some challenged the rationale underpinning the Board's conclusion. For example, one participant in Melbourne argued that the writer of an option should not recognise a liability until it expects the holder to exercise the option (paragraph 29(b) of the background materials). In London participants debated whether a contractual obligation always results in an outflow of economic benefits: most argued 'yes', but others hesitated.

Inconsistent language in IFRS literature

34. One participant noted that IAS 37 provides the only definition of 'probable' in IFRS literature. In the light of wider issues associated with inconsistent language throughout IFRS, he asked the Board not to remove the IAS 37 definition at this stage.² A few participants asked the Board to define probable more generally and then ensure that terms such as probable, more likely than not, expected to, and possible are used consistently throughout IFRS literature.

Probability recognition criterion

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?

No probability recognition criterion is needed

35. Some participants agreed with question 4, especially those representing insurance and actuarial organisations. These participants supported the Board's proposal to reflect uncertainty about items which satisfy the definition of a liability in measurement, rather than precluding recognition. They added that a probability recognition criterion creates an illusion of certainty about the outflow of economic benefits associated with a liability which does not exist. One user in

² Staff comment: The staff notes that 'probable' is defined as 'more likely than not' in both IFRS 3 *Business Combinations* (appendix A) and IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* (appendix A).

Norwalk noted that analysts currently adjust an entity's reported results to incorporate unrecognised liabilities, using limited information in the notes to the financial statements. He suggested that management (ie those with the best understanding of the uncertainties associated these liabilities) are better placed to adjust and then communicate the basis for their adjustments to the market than users.

36. Other participants agreed with question 4, but only if a particular degree of certainty about an outflow of economic benefits is included in the definition of a liability (question 3).

A probability recognition criterion is needed for practical reasons

37. Some participants agreed with the conceptual analysis underpinning the Board's tentative conclusions. But, they favoured retaining a separate probability recognition criterion in IAS 37 as a practical expedient for dealing with uncertainty. Several participants argued that, following the Board's proposal, the level of uncertainty reflected in the measurement of a non-recurring, low probability single obligation would need to be accompanied by a large amount of narrative disclosure. They suggested that non-recognition is more understandable to users and contains the same information, just in a different format. A user in Melbourne agreed, arguing that the overall context in which the financial statements are presented is as important as the numerical content.
38. Other participants favoured retaining a separate probability recognition criterion on cost-benefit grounds because they argued that the combined effect of applying the proposals in questions 3 and 4 would force preparers to spend time and money measuring large numbers of low probability liabilities to prove their immateriality. They argued that the cost to preparers of doing this would outweigh the benefits to users. Some participants agreed that 'more likely than not' is an arbitrary threshold, but suggested that at some point a practical compromise is needed. In London, a few participants suggested a lower threshold

than ‘more likely than not’. But others disagreed, preferring to retain a ‘more likely than not’ threshold.

A probability recognition criterion is needed because liabilities within the scope of IAS 37 are different from liabilities within the scope of other standards

39. Some participants who agreed with questions 3 and 4 conceptually did not agree that *all* liabilities should be recognised. Many objected to paragraph 29(b) in the background materials. They argued that consistency with the recognition of liabilities within the scope of other standards does not necessarily justify omitting the probability recognition criterion in IAS 37. They suggested that there are important differences between liabilities within the scope of IAS 37 and liabilities within the scope of other standards. As a result, a separate probability recognition criterion is acceptable in IAS 37 (even if not in other standards).
40. Following the discussion above, participants debated what makes liabilities within the scope of IAS 37 different from liabilities within the scope of other standards. Some participants suggested that financial liabilities are different from non-financial liabilities because the liability stems from a contract. But other participants did not agree that contractual obligations always satisfy the definition of a liability and/or should be recognised. Other participants suggested that a portfolio of obligations and routine transactions are different from single obligations and non-recurring transactions. But others agreed with the Board’s view, arguing that the unit of account should not affect the existence or recognition of a liability.
41. Participants did not reach a consensus on this issue. But one London participant suggested that it would be useful for the Board to pursue this question, ie when and why are some or all of the liabilities within the scope of IAS 37 different from liabilities within the scope of other standards? He argued that articulating this difference would help both the Board and its constituents understand the inconsistencies between the recognition of liabilities in IAS 37 and other

standards. Also, this participant noted that presenting the probability recognition in IAS 37 in this context would be a conceptual improvement.

Inconsistency with the Framework

42. A small number of participants disagreed with question 4 because the proposal to omit the probability recognition criterion from IAS 37 contradicts the current *Framework*. They argued that the Board should debate removing the probability recognition criterion in the conceptual framework project before proposing changes to individual standards.

Inter-relationship with measurement

43. Some participants felt it was not possible to separate recognition from measurement. For example, they argued that omitting the probability recognition criterion from IAS 37 is acceptable *if* there is no change to the existing measurement guidance (ie single obligations can be estimated at the most likely outcome). But they would oppose omitting the probability recognition criterion *if* the Board proceeded with its proposal to require entities to use expected value to estimate all liabilities within the scope of IAS 37. Other participants argued that it was not possible to separate recognition from measurement because they believe probability has a role in both. Further comments on the Board's approach to redeliberating measurement are included in paragraphs 52-53 below.

RELATED AMENDMENTS

Eliminating the term 'contingent liability'

44. Most participants agreed that it is confusing to use the same term to describe both possible obligations and unrecognised present obligations. But some participants in London and Melbourne opposed the Board's proposal. They asserted that the term 'contingent liability' is well understood and commonly used. A few suggested a compromise: reserve the term for possible obligations (ie items that

do not satisfy the definition of a liability because there is no present obligation on the balance sheet date).

45. More significantly, almost all participants were concerned that eliminating the term contingent liability would reduce the amount of useful disclosure provided about items that do not satisfy the definition of a liability on the balance sheet date. They noted that the ED would require disclosure of uncertainty about the outflow of economic benefits associated with a recognised liability and disclosure about items that satisfy the definition of a liability but are not recognised because they cannot be measured reliably. However, the ED would not require disclosure of uncertainty about the existence of a present obligation (element uncertainty). Participants did not consider the general requirements in paragraph 113 of IAS 1 *Presentation of Financial Statements* sufficient to capture this information.
46. Participants acknowledged the need to balance additional disclosures with volume to ensure an entity's financial statements remain decision-useful. As a result, many asked the Board to start with a clear disclosure principle.

Stand-ready obligations

47. Views on the proposal to introduce the term stand-ready obligation were mixed. One user in Norwalk urged preparers to remain open-minded about using the term. He argued that, although strange at first, it is a neat and useful way of capturing why many items readily accepted as liabilities satisfy the *Framework's* definition.
48. However, some participants in London felt the term should be limited to contractual obligations, or that the Board needs to be very clear about the extent to which the term can be apply to non-contractual obligations. One noted that the term is most useful when dealing with IAS 18 *Revenue* issues in IAS 37 and argued that there is no need to apply the term to non-contractual obligations.
49. In Melbourne, one participant asked whether the term was intended to replace 'contingent liability'. Another suggested that the Board focus on explaining when

and why an item satisfies the definition of a liability and refrain from introducing new terms in any final standard.

MEASUREMENT

Overall approach to redeliberations on measurement

50. Some participants, especially in London and Melbourne, argued that there is no clear objective underpinning the existing measurement principle in IAS 37. They suggested that agreeing upon an objective for liabilities within the scope of IAS 37 should be the first priority in this project. These participants therefore asked the Board to reconsider its decision not to fundamentally debate the measurement objective for IAS 37.
51. As noted in paragraph 45, other participants argued that it was very difficult to comment separately on omitting the probability recognition criterion from IAS 37 (question 4), the measurement principle (question 5) and using expected value to estimate all liabilities within the scope of IAS 37 (questions 6 and 7). This is because they believe that probability has a role in both recognition and measurement. They asked the Board to consider recognition and measurement jointly in the future.

The proposed measurement principle

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?

52. Few participants objected to the statement that the proposed measurement principle is derived from the explanation of ‘best estimate of the expenditure

IAS 37 Round-table Discussions: Summary of outcomes

required to settle' in paragraph 37 of IAS 37. However, many disagreed with the Board's interpretation of a current settlement notion, especially in London and Melbourne. Debate about the existing IAS 37 measurement principle was more limited in Norwalk, perhaps reflecting the fact that many of these participants apply US GAAP rather than IFRS.

IAS 37 is not a current settlement notion

53. Most participants agreed that IAS 37 requires an entity to measure the liability that exists on the balance sheet date, not the liability which may exist in the future. But they did not agree that 'settle the present obligation at the balance sheet date' (IAS 37, paragraph 36) requires an entity to estimate the amount it would pay to settle its obligation *on that date*.
54. Instead, these participants argued that IAS 37 requires an entity to estimate the costs it expects to incur in settling its obligation at some point *after the balance sheet date*, using the best information available on the balance sheet date. They stated that this is accepted practice and one participant felt that question 5 was too academic, urging the Board to look at current practice to interpret the existing guidance rather than dwelling on theoretical arguments.
55. Other participants argued that the Board's interpretation of a current settlement notion equates to fair value. They asked the Board to openly state that it believes the existing IAS 37 requires a fair value measurement and to conduct future redeliberations on that basis.

IAS 37 can be read in more than one way

56. Some participants argued that the ambiguity in IAS 37 means that both interpretations are valid. However, these participants continued to favour accepted practice. One audit firm's representative also referred to past IFRIC discussions to support accepted practice as a valid interpretation of IAS 37.

There is a difference between ‘amount to settle’ and ‘amount to transfer’

57. Most participants argued that ‘amount to transfer’ is typically higher than an ‘amount to settle’. This is because a third party will require (i) a profit margin, and (ii) compensation for assuming an unknown risk. These costs are in addition to payment for assuming the risks inherent in the liability itself. ‘Amount to transfer’ might be lower than ‘amount to settle’ when a third party has specialised knowledge about certain type of liability and therefore can discharge that liability for less than the entity itself.
58. Following this debate, several participants argued that management intent is the appropriate basis for choosing between ‘amount to settle’ and ‘amount to transfer’. That is to say, if management intends to discharge a liability internally then its estimate should reflect the entity’s own costs only. But if management intends to outsource its liability to a third party, then its estimate should reflect the compensation demanded by that third party. Some participants felt that the word ‘rational’ in paragraph 37 of IAS 37 supports this argument because ‘rational’ implies a least cost notion.
59. Other participants linked using management intent as the basis for measuring liabilities with decision-useful information, as defined in the *Framework* (linking question 5 with question 6). This is because it aligns an entity’s balance sheet with expected future cash flows. Other participants linked using management intent with stewardship: allowing users to evaluate management’s past decision about the use of resources entrusted to it.

Other comments

60. A few participants found the explanation of a current settlement notion in the paper confusing. They questioned the difference between a current settlement notion and an ultimate settlement notion because both require an entity to estimate its future cash flows.

Useful information about liabilities within the scope of IAS 37

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 flow (estimated using the individual most likely outcome)? If not, why not?

61. Discussion on question 6 focused on the relative merits of expected value versus individual most likely outcome as an estimation technique. Participants' views were mixed but, due to the law of large numbers, participants agreed that difference between the two techniques is most obvious when considered in the context of single obligations.

Expected value

62. Some participants found the example in appendix A of the background materials useful in understanding the rationale underpinning the Board's tentative conclusion. In particular they agreed that expected value is the superior estimation technique because it captures information about both the range of possible cash flows and their timing. They also agreed that excluding an item that satisfies the definition of a liability from the balance sheet fails to faithfully represent an entity's financial position. Users in Norwalk and London also emphasised that expected value is superior because it reflects new information about a liability as soon as that information becomes available.

63. Nevertheless, many participants who agreed with the theory underpinning question 6 still had practical concerns about using expected value to estimate single obligations (see question 7).

Individual most likely outcome

64. Many participants disagreed with question 6 and thought that the example in appendix A of the background materials was too simplistic. Consistent with paragraph 61 above, these participants argued that expected value fails to meet the objectives of financial statements (defined in the *Framework*) because the end result does not reflect management's best estimate of the entity's future cash flows and, therefore, is not reliable. They argued that users may not understand the difference between the outcome of an expected value calculation and actual cash flows therefore using expected value to estimate single obligations does not provide decision-useful information.
65. Other participants questioned the relevance of expected value, echoing some of the concerns noted in paragraph 57 of the background materials. In particular they argued that expected value fails to reflect economic reality because markets do not exist for most liabilities within the scope of IAS 37. Others argued that forcing entities to recognise liabilities that have a low probability of a high payoff will distort balance sheets and mislead users. Also, a small change in the probability assigned to a such a payoff will cause significant volatility in profit or loss which users will not understand.
66. Instead, these participants favoured using the individual most likely outcome to measure single obligations, coupled with disclosures. They argued that relevant and reliable estimates depend on context and population. Expected value may be an appropriate estimation technique for a portfolio of similar obligations, but not for single obligations.

Other comments

67. Some participants in London noted that both expected value and the individual most likely outcome are useful estimation techniques, but no number is 'richer' or 'better' than another. They agreed that neither model is easy to apply when significant measurement uncertainty exists. But the Board's approach removes

the ability of management to exercise judgement when it is most needed. One Melbourne participant added that in these situations there is only one certainty: an entity's estimate (using any technique) will not be an accurate prediction of an entity's future outflows.

68. These participants suggested that the Board is being too precise in trying to specify one estimation technique for all liabilities within the scope of IAS 37. Instead, they recommended articulating a clear measurement objective, without specifying a particular estimation technique, coupled with appropriate disclosures.

Guidance on how to apply the proposed measurement principle

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?

Practical application difficulties

69. As noted above, even participants who agreed with question 6 expected to encounter difficulties in applying the proposed approach. Concerns mainly focused on non-contractual, non-recurring transactions for which no market or prior information exists. Specific concerns included:
- an entity's ability to source the information required to complete an expected value calculation. For example, will lawyers be willing or able to assign probabilities to the range of possible outcome associated with ongoing legal proceedings?
 - the need for complex models to estimate routine transactions.
 - auditors' ability to verify an expected value calculation, except mechanically.

70. Some participants also suggested that preparers and auditors would require re-education and additional training to provide them with the skills to apply the proposed approach. They questioned whether the costs associated with re-education and training and the additional professional indemnity risk to preparers and auditors of applying the proposed approach outweighed the benefit to users. This is because preparers and auditors will be required to sign-off on an estimate when the least information is available about a liability and when that information is at its least robust.

Methodology

71. Most participants agreed that an ‘expected outflow of benefits’ is not limited to cash outflows. However, one participant pointed to the word ‘expenditure’ in paragraph 36 of IAS 37 measurement principle to suggest that an entity should limit its estimate to cash outflows only.³
72. Some participants refuted the Board’s argument that an ultimate settlement notion (estimated using the individual most likely outcome) would require an entity to predict all future events such as changes in technology and law. They argued that in practice, adjustments to an estimate for future events are limited to situations where objective evidence exists on the balance sheet date. If and when additional evidence subsequently becomes available, an entity updates its estimate.
73. Almost all participants agreed that liabilities should be discounted when the effect of discounting is material. Only one participant disagreed.
74. There was little discussion about risk adjustments. However, a few participants did not agree that IAS 37 already requires an entity to reflect its own credit rating in its estimate of a liability. They noted that paragraph 47 of IAS 37 requires an entity to reflect ‘risks specific to the liability’, not ‘risks specific to the entity’.

³ IAS 37, paragraph 36: ‘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.’ (emphasis added).

Most agreed that an entity can adjust either its probability-weighted cash flows or its discount rate to reflect risk.

Disclosures

75. Many participants argued that practical difficulties in applying the proposed approach could be overcome by either reinstating a probability recognition criterion, or allowing entities to continue using the individual most likely outcome to estimate single obligations. These participants suggested that disclosure can then be used to ensure users are provided with useful information about both recognised and unrecognised liabilities (thus overcoming the conceptual limitations of these options).
76. Several participants also noted that the Board's proposals do not alleviate the need for disclosure, especially when significant uncertainty exists. Therefore the costs associated with applying the Board's approach do not outweigh the benefits. Again, participants emphasised the need to balance additional disclosures with volume and suggested the Board start with a clear disclosure principle. Specific suggestions for additional disclosures relating to measurement included risk concentration and sensitivity analysis.

Other comments

77. Some participants asked that Board to provide more guidance on reliable measurement and the circumstances when a liability might not be capable of being measured reliably.

OTHER COMMENTS

Due process procedures

78. Several participants welcomed the opportunity to participate in round-table discussions. Many asked for another opportunity to comment on the output of any further work on the issues discussed at the round-tables and on the other

proposals (not yet redeliberated). Some asked if the Board planned to re-expose the ED.

79. Participants, especially in London and Melbourne, emphasised the need for a comprehensive cost-benefit analysis of any amendments before proceeding to a final standard. They also asked that the Board consider field-testing its proposals to ensure the full implications are understood and are workable in practice.

CLOSING REMARKS

80. The IASB would like to thank participants for their time and their input into this project.