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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting:	**19 September 2006, London**
Project:	**Liabilities - amendments to IAS 37**
Subject:	**IAS 37 Redeliberations: Scope of the proposed amendments to the IAS 37 measurement principle (Agenda Paper 8A)**

INTRODUCTION

1. The ED proposes limited amendments to the IAS 37 measurement principle. Namely, to emphasise the existing measurement principle and clarify aspects of the accompanying guidance. In particular the ED proposes using expected value to estimate all liabilities within the scope of IAS 37, including single obligations.[1] This paper revisits the Board's decision to limit its amendments to emphasising the existing measurement principle and clarifying aspects of the accompanying guidance only. The proposal to use expected value to estimate all liabilities within the scope of IAS 37 is revisited separately in October.

2. Three alternatives to the approach proposed in the ED are considered in this paper.

   Option 1: Revert back to the wording of the existing IAS 37 measurement principle. That is to day, an entity's 'best estimate' of the expenditure

[1] In this paper the staff uses the term 'expected value' as shorthand for probability-weighted cash flows, discounted to present value and adjusted to reflect the risks and uncertainties associated with the liability.

required to settle the present obligation at the balance sheet date. [paragraphs 13-17]

Option 2: Reconsider the IAS 37 measurement principle. That is to say, identify all possible measurement principles and evaluate the relative merits of each principle to determine which is the most appropriate for liabilities within the scope of IAS 37. [paragraph 18]

Option 3: Adopt fair value as the IAS 37 measurement principle (without identifying and evaluating other possible measurement principles). [paragraphs 19-22]

3. The remainder of this paper is structured as follows:

   (a) Summary of recommendations

   (b) A reminder of previous Board discussions

   (c) Comment letter analysis

   (d) Staff discussion of options 1 - 3

SUMMARY OF RECOMMENDATIONS

4. The staff recommends that the Board affirm its previous decision to emphasise the IAS 37 measurement principle and clarify aspects of the accompanying guidance.

A REMINDER OF PREVIOUS BOARD DISCUSSIONS[2]

5. The IAS 37 measurement principle states that the amount recognised as a liability should be an entity's 'best estimate of the expenditure required to settle the present obligation at the balance sheet date.' When developing the ED, the Board was concerned that 'best estimate' is not a clear measurement principle and therefore may be interpreted in different ways.

6. During its discussions, the Board observed that the FASB believes that fair value is the most relevant and faithful representation of the underlying economics of a transaction. Therefore the FASB has adopted fair value as the

[2] Also refer to the Basis of Conclusions accompanying the ED, paragraphs BC77 - BC79 and agenda paper 4 discussed at the November 2004 Board meeting.

initial measurement principle for liabilities in some recent standards. These include SFAS 146 *Accounting for Costs Associated with Exit or Disposal Activities* and SFAS 143 *Accounting for Conditional Asset Retirement Obligations*.

7. The Board acknowledged that the IAS 37 measurement principle could be interpreted as being close to fair value. But the Board concluded that it would be inappropriate to make fundamental changes to the IAS 37 measurement principle as part of this project given the more far-reaching work on measurement being performed by the concepts team. Therefore, in the ED, the Board limited its amendments to emphasising the existing IAS 37 measurement principle and clarifying aspects of the accompanying guidance.

8. The Board concluded that the best way to meet its limited objective was to use the explanation of 'best estimate' (currently in paragraph 37 of IAS 37) as the measurement principle in the ED. Consequently, the measurement principle proposed in the ED is: An entity shall measure a liability at the amount that it would rationally pay to settle the present obligation or transfer it to a third party on the balance sheet date.

COMMENT LETTER ANALYSIS

Revert back to the wording of the existing IAS 37 measurement principle

9. Some respondents acknowledge that 'best estimate' is not a clear measurement principle and therefore may be interpreted in different ways. Nevertheless, some respondents suggest that the Board refrain from making *any* amendments to the IAS 37 measurement principle as part of this project. This is because the Board is already discussing measurement issues in other projects such as the conceptual framework, insurance and fair value measurement. These respondents suggest that the Board resolve the issues in these projects before making any amendments to the IAS 37 measurement principle. For example, [one respondent] recommends that 'the IASB should firstly address the issue through a review of the Framework rather than as a standalone change in an individual IFRS.'

Adopt fair value as the IAS 37 measurement principle

10. Several respondents comment that the ED implicitly establishes fair value as the IAS 37 measurement principle. Respondents ask the Board to explicitly confirm that the proposed measurement principle is fair value, or explain the difference between the proposed measurement principle and fair value.

11. A few respondents would support adopting fair value as the IAS 37 measurement principle. For example, [one respondent] suggests that the Board 'consider deleting the guidance in paragraphs 31-32 of the proposals and cross reference to the fair value measurement guidance from the fair value measurement project'. Similarly, [another respondent] recommends that the Board 'take the opportunity to ensure that non financial liabilities are measured at fair value.'

12. But most respondents object to the proposed measurement principle in the ED because they do not believe fair value is an appropriate measurement principle for liabilities within the scope of IAS 37. The arguments put forward by these respondents include:

    (i) fair value is not the most relevant basis for liabilities within the scope of IAS 37. This is because often an entity would not and/or could not transfer such a liability to a third party at the balance sheet date.[3]

    (ii) measuring a liability at fair value does not reflect the ultimate expected payment to settle the obligation and therefore is less useful to users.[4]

    (iii) it is counterintuitive to adopt fair value as the IAS 37 measurement principle when liabilities within the scope of IAS 37 are not risk managed on a fair value whereas IAS 39 *Financial Liabilities: Recognition and Measurement* requires accrual accounting for liabilities that are risk managed on a fair value basis.

    (iv) measuring a liability at fair value is akin to a legal lay-off approach. A legal lay-off approach contradicts the requirement to prepare financial

[3] For example, [one respondent] comments 'The overwhelming majority of provisions do not relate to obligations for which an active market exists, or in many cases, a third party could be found to assume.'

[4] For example, [one respondent] notes 'Application to a single obligation may produce a liability that is not helpful for account users, differing very significantly as it does from the actual, realised outcome.'

statements on a going concern basis and the limitations of such an approach have already been acknowledged in the revenue recognition project.

STAFF DISCUSSION

Option 1: Revert back to the wording of the existing IAS 37 measurement principle

13. The staff acknowledges that the Board's decision to make limited amendments to the measurement guidance may be viewed as an unsatisfactory compromise. However, the staff continues to believe that 'best estimate' is not a clear measurement principle and therefore may be interpreted in different ways.

14. This concern is supported by the comment letters themselves. That is to say, the comment letters indicate that different interpretations of the IAS 37 measurement principle exist today (thereby justifying the Board's concerns about the phrase 'best estimate').

15. The Board's previous discussions indicate that it understands the IAS 37 measurement principle to be a *current* settlement notion, represented by an entity's 'best estimate' of the range of possible outcomes associated with the liability – that is to say, the *expected value* of the liability. And some respondents agree.[5] But the comment letters suggest that many respondents consider the existing IAS 37 measurement principle to be an *ultimate* settlement notion, represented by an entity's 'best estimate' of the individual *most likely* cash outflow required to settle a liability.

16. Different interpretations may result inconsistent application of the Standard. In turn, inconsistent application may reduce the comparability and decision-usefulness of information reported in an entity's financial statements. Carrying forward 'best estimate' would only perpetuate this problem. Therefore the staff does not recommend that the Board retain the existing IAS 37 measurement principle.

17. Moreover, as discussed in November 2004, the staff continues to believe that the concept of an unconditional stand-ready obligation underlines the need to

[5] For example, the [one respondent] states 'We do not consider the basis of measurement in IAS 37 is being altered fundamentally. The proposal seems a reasonable clarification of the existing model.'

emphasise the existing measurement principle, particularly the use of expected value. This is because expected value is the only estimation technique that reflects the range of possible outcomes in the measurement of a liability.[6]

Option 2: Reconsider the IAS 37 measurement principle

18. In many respects the ideas and proposals emerging from this project are more extensive than first envisaged. Therefore, some may view the current project as an opportunity to fundamentally reconsider all aspects of IAS 37, including the measurement principle. However, the staff does not recommend fundamentally reconsidering the IAS 37 measurement principle as part of this project for the following reasons:

    (a) Reconsidering the measurement principle is not necessary to meet the project objectives. These were affirmed at the February 2006 Board meeting as (i) analysing items currently described as contingent assets and contingent liabilities in terms of assets and liabilities as defined in the *Framework*, and (ii) converging the IAS 37 application guidance on recognising costs associated with restructurings with the guidance in SFAS 146.

    (b) The staff continues to believe it is appropriate to defer any decision to change the IAS 37 measurement principle until further progress is made in the measurement phase of the concepts project. Attempting to identify and evaluate all possible measurement principles for liabilities within the scope of IAS 37 as part of this project would be a duplication of effort for short-term benefits only.

    (c) Identifying and evaluating the relative merits of all available measurement principles for liabilities within the scope of IAS 37 is a significant undertaking and would extend the scope of this project. Extending the scope of this project is likely to delay redeliberations. The Board has identified IAS 37 as a precedential project therefore any delay in this project would also impact other related projects. (In making this observation the staff is not wishing to imply that

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[6] The staff acknowledges that the Board initially agreed to emphasise the use of expected value in May 2003, *before* the new analysis of liabilities was finalised (in October 2003 and March 2004). Nonetheless, emphasising the existing measurement principle and the use of expected value is consistent with the Board's new analysis of liabilities.

reconsidering the IAS 37 measurement principle should be rejected on this basis alone, merely that the full consequences of any delay should be considered in reaching a decision.)

Option 3: Adopt fair value as the IAS 37 measurement principle

19. The Board has already acknowledged similarities between the IAS 37 measurement principle and fair value. So too have many respondents. In particular, the staff notes that:

- the difference between the proposed measurement principle (amount to transfer an obligation to a third party at the balance sheet date) and fair value is not clear. The most recent definition of fair value discussed by the IASB in the fair value measurement project is 'the price that would be received for an asset or paid to *transfer a liability* in a transaction between market participants *at the measurement date*'[7] (emphasis added).

- neither the IAS 37 ED nor the IFRS 3 ED explains the transition between measuring a liability assumed as part of a business combination at fair value on day 1 and measuring the same liability in accordance with IAS 37 on day 2. This suggests that the Board considers the proposed measurement principle to be comparable to the fair value measurement principle in a business combination.

20. Moreover, paragraphs 3 and 4 in the Introduction to the ED state that the Board believes its proposed amendments to IAS 37 would achieve substantial convergence with the recognition principles in FAS 146 and FAS 143. As noted in paragraph 6, fair value is the initial measurement principle in these standards (although fair value is not the day 2 measurement principle in either standard). Extending convergence to include the adoption of fair value as the measurement principle in IAS 37 may be viewed as a further step towards convergence with US GAAP.

21. But the staff believes that it is not appropriate to adopt fair value as the IAS 37 measurement principle at this time. This is because the definition of fair value

[7] Definition discussed by the IASB in May 2006 (see agenda paper 8A) and included in the Fair Value Measurement Standard working draft available on the FASB website on 10 July 2006.

is currently being developed.[8] Without an accepted definition of fair value the staff believes it would be very difficult to determine whether the proposed measurement principle is the same as fair value. If the proposed measurement principle is not the same as fair value, without a definition it would be difficult for the staff to evaluate the merits of adopting fair value as the IAS 37 measurement principle.

22. As the fair value measurement project progresses, the Board might conclude that the proposed measurement principle is the same fair value or that fair value should be adopted as the IAS 37 measurement principle. However, the staff thinks that it would be premature to reach such a conclusion at this point in time.[9]

Conclusion

23. Based on the analysis above the staff recommends that the Board affirm its previous decision to emphasise the existing IAS 37 measurement principle and clarify aspects of the accompanying guidance.

24. As noted in paragraph 15 some respondents do not agree with the Board's interpretation of the IAS 37 measurement principle. Therefore agenda paper 8B revisits the Board's interpretation of the IAS 37 measurement principle and seeks to understand why different interpretations have arisen.

[8] The fair value measurement guidance project is work in progress. In light of the Board's recent decision to publish a discussion paper rather than progressing directly to an ED, a final fair value measurement IFRS is not expected until 2008 at the earliest.
[9] This approach is consistent with that taken the insurance project.