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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: Reconsidering the existing IAS 37 measurement principle (Agenda Paper 8B)**

INTRODUCTION

1. 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'. Previous discussions about the IAS 37 measurement principle indicate that the Board understands the existing principle to be a *current* settlement notion.

2. The measurement principle proposed in the ED is also a current settlement notion: 'the amount an entity would rationally pay to settle the present obligation or to transfer it to a third party on the balance sheet date'. Therefore the Board regarded the proposed amendments as emphasising, rather than changing, the existing IAS 37 measurement principle.

3. However, as noted in agenda paper 8A, many respondents do not share the Board's understanding of the existing IAS 37 measurement principle. The comment letters suggest that many respondents understand the existing IAS 37 measurement principle to be an *ultimate* settlement notion. Consequently

these respondents regard the proposed amendment to the measurement principle as more significant than the Board intended.

4. The purpose of this paper is (a) to explain why the Board understands the IAS 37 measurement principle to be a current settlement notion; and (b) to understand why many respondents do not share this understanding. Having identified the "gaps" in understanding of the existing IAS 37 measurement principle, this paper goes on to consider how we might close the "gaps".

5. After the summary of recommendations, the staff's analysis is structured as follows:

Section A: Why the existing IAS 37 measurement principle is a current settlement notion [paragraphs 7-22]

Section B: Why many respondents do not share the Board's understanding of the existing IAS 37 measurement principle [paragraphs 23-30]

Section C: Closing the gap: how the ED clarifies the IAS 37 measurement principle [paragraphs 33-34]

Section D: Closing the gap: opportunities to improve the explanation of the measurement principle in the ED [paragraphs 35-45]

SUMMARY OF RECOMMENDATIONS

6. The staff asks that the Board to affirm that it understands the existing IAS 37 measurement principle to be a current settlement notion.

A. WHY THE EXISTING IAS 37 MEASUREMENT PRINCIPLE IS A CURRENT SETTLEMENT NOTION

7. This paper begins by analysing why the IAS 37 measurement principle is a current settlement notion. The staff's analysis begins by examining the existing text of IAS 37 and then, in the absence of a Basis for Conclusions accompanying IAS 37, considers the papers and discussions of the IASC preceding the issue of IAS 37 in 1998.

The existing text of IAS 37

The measurement principle

8. 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*' (paragraph 36, emphasis added).

9. The wording of the measurement principle itself is the first point of reference indicating that the measurement principle is a current settlement notion. The phrase 'to settle the present obligation' suggests that a liability within the scope of IAS 37 is measured as the amount an entity would have to pay to fully extinguish its obligation, whether today or in the future.[1] But including the phrase 'at the balance sheet date' clarifies that the IAS 37 measurement principle is a current settlement notion – in other words, an entity's best estimate is the amount it would pay to fully extinguish its obligation today, not in the future.

Explaining the measurement principle

10. The IAS 37 measurement principle and the notion of 'best estimate' are explained further in the text of IAS 37. This explanation emphasises that the IAS 37 measurement principle is a current settlement notion. For example, paragraph 37 reads:

> 'The best estimate of the expenditure required to settle the present obligation is the amount that an entity would rationally pay to settle the obligation at the balance sheet date or *to transfer it to a third party at that time*. …' (emphasis added)

11. [Paragraph omitted from observer note]

12. Paragraph 37 goes on to acknowledge that it will often be impossible or prohibitively expensive for an entity to settle or transfer an obligation at the balance sheet date. Nevertheless, paragraph 37 concludes that an estimate of the amount an entity would rationally pay to settle or transfer an obligation at the balance sheet date gives the best estimate of the expenditure required to

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[1] The Concise Oxford English Dictionary defines the verb 'to settle' as 'to reach an agreement or decision about (an argument or a problem); pay (a debt or account)'. Alternative verbs listed in the www.freedictionary.com thesaurus include resolve, clear (as in clear a debt), conclude, terminate and end. The staff also notes that the idea of settlement 'over time' or 'in instalments' is not consistent with the dictionary definition.

settle the present obligation at the balance sheet date. Once again this emphasises that an entity's best estimate is a current settlement notion, rather than an ultimate settlement notion.

Probability-weighted cash flows (expected value)

13. The guidance in paragraphs 39 - 40 of IAS 37 requires an entity to use probability-weighted cash flows (expected value) to estimate a liability. The use of expected value emphasises that the measurement principle is a current settlement notion because it requires an entity to take into account the range of possible outcomes when measuring a liability, rather than the individual most likely cash outflow that will be required to settle the liability. [Remainder of paragraph omitted from observer notes]

14. Paragraph 40 does allow that for single obligations, the individual most likely outcome may be the best estimate of the liability. Nonetheless, an entity should not ignore other possible outcomes:

> 'Where a single obligation is being measured, the individual most likely outcome may be the best estimate of the liability. *However, even in such a case, the entity considers other possible outcomes. Where other possible outcomes are either mostly higher or mostly lower than the most likely outcome, the best estimate is will be a higher or lower amount*. …' (emphasis added)

Risks and uncertainties

15. Paragraphs 42 – 44 of IAS 37 explain that the risks and uncertainties surrounding many events and circumstances should be taken into account in reaching a best estimate of a liability. This is consistent with a current settlement notion because a rational third party would demand compensation relative to the degree of risk and uncertainty assumed.

16. For example an entity may estimate that the expected value of its portfolio of product warranties is CU100,000. This estimate may be based on twenty years of past experience with the exact products covered by the warranty. Alternatively this estimate may be based on twenty years of past experience with similar products to those covered by the warranty, but no experience of the exact product covered by the warranty. In both scenarios a third party is unlikely to assume this obligation for CU100,000 *per se*. But a rational third

party would demand more compensation for assuming a portfolio of warranties in the second scenario because the degree of risk and uncertainty associated with the expected value of CU100,000 is higher than the degree of risk and uncertainty associated with the expected value of CU 100,000 in the first scenario.

Present value

17. Paragraphs 45 – 47 of IAS 37 require an entity to reflect the time value of money when measuring a liability. This is achieved by discounting estimated cash flows. This requirement supports the conclusion that the IAS 37 measurement principle is a current settlement notion, not an ultimate settlement notion. This is because a discounted estimate represents the economic value of a liability today. In contrast the undiscounted sum of future cash flows represents the total costs to settle a liability at a date in the future, ignores the time value of money.

The development of IAS 37

18. In the absence of a Basis for Conclusions, the agenda papers and working drafts of IAS 37 discussed by the IASC Board and Steering Committee for Provisions and Contingencies provide some insight into the rationale underpinning the measurement principle and guidance when IAS 37 was approved for issue in 1998.

19. The Draft Statement of Principles (DSOP) and the Exposure Draft (ED59) issued by the IASC prior to the final Standard indicate that the IASC intended the measurement principle to be a current settlement notion.[2] For example, paragraph 35 of the DSOP reads:

‘In principle, the amount that is recognised in respect of a provision should represent the amount of the obligation that existed at balance sheet date. This amount is often expressed as *the amount which represents as closely as possible what the enterprise would have to pay a third party to assume its obligation*. Accordingly, in principle, *the amount of a provision should be estimated from market value*.’ (emphasis added)

and paragraph 24 of ED59 reads:

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[2] The Draft Statement of Principles was approved by the IASC Steering Committee on Provisions and Contingencies in 1996 and ED59 was approved by the IASC Board in 1997.

> ‘The amount that is recognised for a provision represents the amount of the obligation at balance sheet date. This amount is often expressed as the amount which represents as closely as possible what the enterprise would rationally pay to settle the obligation *immediately* or to *provide consideration to a third party to assume it*.’ (emphasis added)

20. [Paragraph omitted from observer note]

21. The suggestion that the IAS 37 measurement principle is a current settlement notion (because there is no intended difference between the explanation in ED59 and the explanation in the final Standard) is supported by the outcome of harmonisation projects undertaken by some national standard-setters prior to the adoption of IFRS. [Remainder of paragraph omitted from observer note].

22. The Board’s understanding that the existing IAS 37 measurement principle is a current settlement notion is also consistent with some commentaries on IAS 37 which were completed independently of the IASC/IASB and this project. [Remainder of paragraph omitted from observer note].

B. WHY MANY RESPONDENTS DO NOT SHARE THE BOARD’S UNDERSTANDING OF THE EXISTING IAS 37 MEASUREMENT PRINCIPLE

23. This section of the paper seeks to identify why many respondents do not share the Board’s understanding of the IAS 37 measurement principle. The staff has identified two reasons: inconsistency in the existing text of IAS 37 and misconceptions about the output of an expected value calculation.

The existing text of IAS 37

The measurement principle itself

24. The Board has already observed that ‘best estimate’ is not a clear measurement principle and therefore may be misinterpreted. The Board is not alone in making this observation. For example the FASB has observed that many accountants equate ‘best estimate’ with ‘most likely outcome’. But statisticians, actuaries, scientists and engineers use the term ‘best estimate’ to

describe expected value.[3] In US GAAP Concepts Statement No. 7 *Using Cash flow Information and Present Value in Accounting Measurements* addresses this anomaly.

Explaining the measurement principle

25. In section A we noted that the explanation of 'best estimate' in paragraph 37 of IAS 37 emphasises that the measurement principle is a current settlement notion.

26. But other sections are of the existing text are not always as clear. As noted above, paragraph 40 allows that the best estimate of a single obligation may be 'the individual most likely outcome'. Although not explicitly presented as such, this statement may be read as an exception to the measurement principle. This exception may have contributed to the perception that the IAS 37 measurement principle is an ultimate settlement notion, represented by the individual most likely cash outflow required to settle a liability.

27. [Paragraph omitted from observer note]

The output of an expected value calculation

28. In the comment letters many respondents object to using expected value to measure single obligations. But few respondents object to using expected value to measure portfolios of similar obligations. The arguments articulated in the comment letters suggest that many respondents do not view expected value as a current settlement notion, even for a portfolio of obligations. That is to say, the reason why so few respondents object to using expected value to measurement a portfolio of similar obligations is because the law of larger numbers means that the output of the calculation is closer to the settlement amount for a portfolio of obligations than for a single obligation.

29. For example, [one respondent] argues that expected value 'will always give the wrong answer as this contrived total is highly unlikely to be the actual value of the final settlement (if any).' Similarly [another respondent] comments 'application [of expected value] to a single obligation may produce

[3] Expected Cash Flows by Edward W. Trott and Wayne S. Upton, *Understanding the Issues*, May 2001, Volume 1, Series 1.

a liability that is not helpful for account users, differing very significantly as it does from the actual, realised outcome.'

30. Again, the exception to expected value permitted in paragraph 40 may also have contributed to misconceptions about the output of an expected value calculation.

Conclusion

31. Based on the analysis provided in sections A and B, the staff asks the Board to affirm that it understands the existing IAS 37 measurement principle to be a current settlement notion, not an ultimate settlement notion.

32. Having identified the "gaps" in understanding of the IAS 37 measurement principle, sections C and D of this paper consider how we might close these "gaps". Section C evaluates the steps already proposed in the ED and Section D identifies further opportunities.

C. CLOSING THE GAP: HOW THE ED CLARIFIES THE IAS 37 MEASUREMENT PRICIPLE

33. The Board has already taken a number of steps to clarify the IAS 37 measurement principle in the ED. These steps are:

- replacing 'best estimate' as the IAS 37 measurement principle with the explanation of best estimate in paragraph 37. As noted in paragraphs 10-12 above, paragraph 37 clearly explains that the IAS 37 measurement principle is a current settlement notion - that is to say, the amount an entity would have to pay to extinguish its obligation in full at the balance sheet, not in the future.

- editorial revisions to the text in the ED to eliminate any inconsistency between the measurement principle and supporting guidance. [Remainder of paragraph omitted from observer note]

- emphasising that expected value is an appropriate estimation technique for measuring all liabilities within the scope of IAS 37. The option to use the 'individual most likely outcome' as an alternative estimation technique for single obligations has been removed.

34. The comment letters indicate that the Board has successfully met its objective to clarify the IAS 37 measurement principle. Whilst objecting to the proposed amendments to the measurement principle, most respondents clearly understand that the proposed measurement principle is a current settlement notion and that expected value should be the estimation technique used to measure all liabilities within the scope of IAS 37. The comment letters do not identify any inconsistencies between the amended measurement principle and the amended text in the ED.

D. CLOSING THE GAP: OPPORTUNITIES TO IMPROVE THE EXPLANATION OF THE MEASUREMENT PRINCIPLE IN THE ED

35. Although ED successfully explains that its measurement principle is a current settlement notion, a shared understanding of the ED's measurement principle and guidance does not mean respondents agree that the *existing* IAS 37 measurement principle is a current settlement notion (and therefore the proposed amendments are limited). Nor does it resolve misconceptions about the output of an expected value calculation.

36. The staff has identified three opportunities to improve the explanation of the measurement principle in the ED:

- Explaining how using a current settlement notion as the base for the IAS 37 measurement principle and using expected value to estimate liabilities within the scope of IAS 37 provides useful information.

- Providing additional guidance, or further clarifying aspects of the existing guidance, to demonstrate how expected value can be used to estimate all liabilities within the scope of IAS 37 (including single obligations).

- Re-examining the proposed measure principle to address respondents' concerns about a perceived choice in the principle.

Useful information

37. Despite the fact the comment letters indicate that a majority of respondents understand that the ED's measurement principle is a current settlement notion, many object to using a current settlement notion as the base of the

measurement principle. A common argument is that current settlement does not provide useful for users. Moreover, as noted above, many respondents use the same argument in disagreeing with the proposal to use expected value to measure all liabilities within the scope of IAS 37.

38. The staff proposes addressing these concerns by explaining how using a current settlement notion as the base for the IAS 37 measurement principle and using expected value to estimate all liabilities within the scope of IAS 37 provides useful information. This opportunity for improvement is explored in more detail in agenda paper 8C.

Providing additional guidance

39. Many respondents request further guidance on how to use expected value to measure liabilities within the scope of IAS 37, especially single obligations. Others suggest an exception to expected value in some instances. In particular respondents are concerned that: (a) when no market evidence or past experience is available, the degree of judgment and subjectivity required to complete an expected value calculation may be too great to be capable of reliable measurement; and (b) in some instances, the cost to preparers of using expected value to measure all obligations may outweigh the benefits to users.

40. Other respondents ask the Board to clarify specific aspects of the existing guidance. For example, whether incremental expenses associated with a liability should be included in the measurement of that liability and whether the effect on an entity's own credit risk should be reflected in the measurement of a liability.

41. The staff notes that the nature and extent of guidance provided in the ED is broadly consistent with that currently provided in IAS 37. That is to say, the ED has not reduced the amount of guidance available in the text of the Standard. The illustrative examples accompanying the ED also demonstrate how information can be used to complete an expected value calculation.[4] Also, providing additional guidance, or clarifying aspects of the existing guidance, may create tension with the staff's recommendation in agenda paper

[4] ED, illustrative example 17

8A – to limit the scope amendments to measurement in this project to emphasising the measurement principle and clarifying aspects of the guidance.

42. However, the comment letters indicate that many respondents are not sure how they would apply expected value to liabilities in the scope of IAS 37 in practice (even if they understand and agree with the theory). This may create differences in practice, resulting in inconsistency and confusion. Therefore this opportunity for improvement is explored in more detail in agenda paper 8D. The need for exceptions to the measurement principle will presented to the Board for discussion in October 2006.

Choice permitted in the ED's measurement principle

43. By retaining the current wording of paragraph 37, the proposed measurement principle expresses the current settlement notion using two different phrases – the amount to settle <u>or</u> to transfer an obligation at the balance sheet date.

44. Some respondents think that 'to settle' is an entity-specific measure and 'to transfer' is a market-based measure. Several note that a market-based measure of a liability would include a profit margin required by a third party to assume the liability whereas an entity-specific measure would not. Therefore respondents are concerned that the proposed measurement principle may result in two different measures of the same liability. Other respondents question whether the Board intended the amended measurement principle to be perceived as permitting choice.

45. This concern was identified as issues requiring further discussion in the comment letter summary and plan approved by the Board at the start of redeliberations.[5] The staff continues to believe that this issue merits further examination and intends to present its analysis to the Board in October 2006.

APPENDIX A: Extracts from a selection of commentaries on IAS 37 completed independently of the IASB/IASC and this project

[Appendix omitted from observer note]

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[5] February 2006 agenda paper 8, page 24