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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: Will the proposed measurement principle provide useful information? (Agenda Paper 8C)**

INTRODUCTION

1. 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.[1] The staff believes that a measurement principle based on a current settlement notion meets this objective because it captures the most recent information about liabilities. But many respondents are concerned that a measurement principle based on a current settlement notion will not provide useful information about liabilities within the scope of IAS 37.

2. The purpose of this paper is to first identify, and then address, respondents' concerns about how a measurement principle that is based on a current settlement notion provides useful information about liabilities within the scope of IAS 37. In doing so, this paper aims to alleviate concerns about the measurement principle proposed in the ED (regardless of whether respondents agree that the existing IAS 37 measurement principle is based on a current

[1] *Framework*, paragraph 12.

settlement notion) and dispel misconceptions about the output of an expected value calculation. [2]

3. Concerns about how to apply the proposed measurement principle in practice are discussed separately in agenda paper 8D. Exceptions to the proposed measurement principle (if any) will be presented for discussion at the next Board meeting. Therefore these topics are not included in this paper.

4. After the staff recommendation the remainder of this paper is structured as follows:

Section A: Comment letter summary [paragraphs 6-15]

Section B: The need for further explanation [paragraphs 16-23]

Section C: How a measurement principle based on a current settlement notion provides useful information about liabilities within the scope of IAS 37 [paragraphs 24-56]

STAFF RECOMMENDATION

5. The staff recommends including an explanation of how a measurement principle based on a current settlement notion provides useful information about liabilities within the scope of IAS 37 in the Basis for Conclusions accompanying any final Standard.

A. COMMENT LETTER SUMMARY

Decreasing the relevance of financial information

6. IAS 37 and the ED both acknowledge that an entity often could not or would not settle or transfer liabilities within the scope of IAS 37 at the balance sheet date because no market exists. Many respondents use the absence of a market to argue that a current settlement notion is not a relevant measurement base for liabilities within the scope IAS 37. In particular these respondents comment that measuring a liability based on a hypothetical market fails to reflect economic reality. For example, [one respondent] argues '… recognition of

[2] 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.

improbable outflows of economic resources would obscure the users' understanding of real and ascertained obligations that are likely to give rise to outflows'.

7. Other respondents perceive a current settlement notion to be measurement on a break-up or liquidation basis because it does not take into account an entity's future expectations. These respondents argue that this approach contradicts the going concern basis of preparing accounts used by most entities.

8. These respondents favour a measurement principle based on an ultimate settlement notion (the amount an entity expects to pay in the future). They argue that an ultimate settlement notion would provide more relevant information because it would reflect the cash outflows an entity expects to incur in settling its obligation in the real world.

Decreasing the reliability of financial information

9. Many respondents disagree with the proposed measurement principle because they are not convinced that a measurement principle based on a current settlement notion enables reliable measurement of liabilities within the scope of IAS 37. In particular respondents are concerned that the absence of a market will increase reliance on subjective estimates.

10. Some respondents are concerned that the use of subjective estimates increases the risk of inappropriate earnings management. This risk is particularly pertinent from one period to the next because a small change percentage change in one variable may have a material impact on an entity's estimate of a liability and therefore on an entity's earnings. These respondents argue that the risk of inappropriate earnings management decreases the perceived reliability of financial information. It may also reduce the users' ability to compare an entity's results from one period to the next and to the results of other entities.

11. Other respondents also note that increased reliance on subjective estimates may prove difficult to independently verify. For example, [one respondent] observes that the proposed measurement principle 'will require preparers to make highly subjective assumptions. At the same time, auditors will be

expected to testify their objectivity and reliability. We doubt this will be feasible'.

Decreasing the understandability and comparability of financial statements

12. Some respondents note that a measurement principle based on a current settlement notion is likely to increase volatility in the income statement. For example subsequent changes in discount rates will be reflected in the re-measurement of a liability at each balance sheet date and therefore in the income statement for that reporting period. These respondents argue that increased volatility in the income statement will make it more difficult for users to understand changes in an entity's earnings and compare an entity's earnings from one period to the next.

13. Other respondents are concerned that the current income statement is not capable of differentiating between changes in estimates (discount rates, risk adjustments, and so on) and changes in an entity's operating result. Therefore information about the underlying liability itself may be obscured.

The 'wrong' answer

14. The comment letters indicate that many respondents equate useful information with the proximity of an entity's estimate to actual cash outflows. In other words, a useful estimate is one which is close to the cash outflow required to settle the liability. These respondents object to a measurement principle based on a current settlement notion because a current settlement notion (estimated using expected value) does not aim for the ultimate cash outflow. Therefore the resulting estimate would not be useful to users because is unlikely to equal any one of the future possible outcomes.

15. Again these respondents favour a measurement principle based on an ultimate settlement notion because it estimates the amount an entity expects to pay in the future. Therefore the output is aligned to an entity's expectation of the actual cash outflow required to settle the liability.

B. THE NEED FOR AN EXPLANATION

16. The staff believes that it is necessary to explain how a measurement principle based on a current settlement notion provides useful information about

liabilities within the scope of IAS 37 as part of this project for two reasons. First, alternative sources of information are limited and do not specifically consider liabilities within the scope of IAS 37. Secondly, the comment letters indicate that concerns about the usefulness of the proposed measurement principle are pervasive.

Alternative sources of information

Existing explanations

17. Discussion of the conceptual merits of a measurement principle based on a current settlement notion already features in accounting literature.[3] Board members and some constituents are already familiar with this literature. But others may not be. For example, recent adopters of IFRS may not yet be familiar with non-authoritative IASB literature such as discussion papers and exposure drafts (due to the time invested in converting from national GAAP to existing IFRS for example). Discussion of how a liabilities measurement principle based on a current settlement notion provides useful information is limited in the existing IASB authoritative guidance.

18. Moreover, existing explanations do not explain how a measurement principle based on a current settlement notion provides useful information *about liabilities within the scope of IAS 37*. For example, Concepts Statement No. 7 discusses some liability-specific issues but its objective is broader than liabilities within the scope of IAS 37. Also, the current IAS 37 is not accompanied by a Basis for Conclusions. Therefore explanation specific to liabilities within the scope of IAS 37 is not readily available.

Forthcoming explanations

19. A comprehensive analysis of all measurement bases, including current settlement, will be discussed by the Board as part of the conceptual framework project. This analysis may alleviate the need to explain how a measurement principle based on a current settlement notion provides useful information. However, the staff notes that the scope of the conceptual framework project

[3] For example, Appendix A to IAS 36 *Impairment of Assets*, Concepts Statement No. 7 *Using Cash Flow Information and Present Value in Accounting Measurements* and the IASB discussion paper *Measurement Bases for Financial Accounting – Measurement on Initial Recognition*, issued in November 2005.

encompasses measurement of all assets and liabilities. Therefore any resulting explanation may not be tailored to address issues specific to liabilities within the scope of IAS 37. Also, no authoritative guidance on measurement is expected to result from the conceptual framework project in the short-term.

Pervasiveness

20. The comment letters indicate that concerns about the usefulness of the proposed measurement principle are pervasive. An analysis of the comment letters does not indicate that these concerns are limited to one geographic region or industry group.

21. The absence of geographic or industry trends might suggest that many constituents are not familiar with existing literature. In this case, capturing appropriate extracts from the literature in one place may facilitate easier access to this literature for a greater number of constituents.

Conclusion

22. Based on the analysis above, the staff recommends explaining how a measurement principle based on a current settlement notion provides useful information about liabilities within the scope of IAS 37 as part of this project. The staff also recommends including a summary of this explanation in the Basis for Conclusions accompanying any final Standard.

23. The staff proposes to (a) draw on existing accounting literature to explain how a measurement principle based on a current settlement notion provides useful information; and (b) illustrate this explanation with examples that relate to liabilities within the scope of IAS 37. The staff does not propose introducing new ideas for debate. Therefore significant Board discussion time (which would lengthen redeliberations) is not anticipated.

C. HOW A MEASUREMENT PRINCIPLE BASED ON A CURRENT SETTLEMENT NOTION PROVIDES USEFUL INFOMRATION ABOUT LIABILITIES WITHIN THE SCOPE OF IAS 37

24. This section of the paper responds to the concerns about a measurement principle based on a current settlement notion outlined in section A. In doing so this section places particular emphasis on the attributes of useful

information described in the existing IASB *Framework*. This includes relevance, reliability (neutrality, faithful representation and verfiability), comparability and understandability.

Relevance

25. The *Framework* explains that to be useful, information must be relevant to the decision-making needs of users. Information is relevant when it helps users to evaluate the potential effects of past, present or future events on future cash flows (predictive value), or to confirm or correct past evaluations (confirmatory value).[4] The phrase 'capable of making a difference' to the decision of users is commonly used in the context of relevance. Respondents are mainly concerned that a current settlement notion does not have predictive value.

26. Predictive value means that an item has value as an input into a predictive process. It does not mean that the information itself is a prediction or a forecast. A current settlement notion (estimated using expected value) has predictive value because it incorporates all available information in the measurement of a liability. Therefore the output provides users an estimate that considers the range of possible outcomes associated with a liability at the balance sheet date. Consider the following example[5]:

> Entity A has violated an industry regulation. The maximum penalty for violating this regulation is a fine of CU100,000. The regulator has the discretion to reduce this fine. Entity A has no ability to influence the decision of the regulator and is not able to avoid paying any fine imposed. Therefore Entity A has a liability.
>
> But this is the first time Entity A has violated an industry regulation. Based on the evidence available at the balance sheet date management estimate there to be a 40% probability that the regulator will fine Entity A CU100,000 and a 60% probability that the regulator will reduce the fine to CU50,000.

[4] *Framework*, paragraph 28 and the *Discussion Paper on Preliminary Views on an improved Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics of Decision-useful Financial Reporting Information*, paragraph QC8 – QC15.
[5] For simplicity this example does not include a risk adjustment or discount the liability to present value.

27. The expected value of the fine is CU70,000. CU70,000 does not represent either of the possible outcomes. But including both possible outcomes when estimating Entity A's liability has predictive value because it provides users with an estimate which considers the range of possible outcomes.

28. Using an ultimate settlement notion, Entity A would estimate its liability to be CU50,000 (being the individual most likely cash outflow). This is useful information. But this estimate omits relevant information from the balance sheet because knowledge of the potential fine of CU100,000 could be capable of making a difference to users of Entity A's financial statements.

29. A current settlement notion also has predictive value because it allows an entity to reflect new information about the facts and circumstances associated with a liability as they emerge. Consider the following example[6]:

> **Year 1** – Entity Z has violated a law and therefore records a liability. At the balance sheet date legal advice indicates there to be a 5% chance that Entity Z will be required to pay CU600,000 to settle the claim, a 60% chance that Entity Z will be required to pay CU450,000, a 30% chance that Entity Z will be required to pay CU350,000 and a 5% change that Entity Z will be required to pay CU200,000 to settle the claim.
>
> The expected value of the liability is CU415,000.
>
> **Year 2** – The liability has not been settled at the end of year 2. But new and unfavourable evidence has come to light during the year. Therefore legal advice now indicates there to be a 10% chance that Entity Z will be required to pay CU600,000 to settle the claim, a 70% chance that Entity Z will be required to pay CU450,000, a 15% chance that Entity Z will be required to pay CU350,000 and a 5% change that Entity Z will be required to pay CU200,000 to settle the claim.
>
> The expected value of the liability is CU437,500 (an increase of CU22,500 or 5.4%).

30. Using a current settlement notion, Entity Z reflects new information in the measurement of its liability in year 2. Therefore users have the ability to

[6] For simplicity this example does not include a risk adjustment or discount the liability to present value.

assess the impact of the change in facts and circumstances relating to the lawsuit on a timely basis.

31. In contrast, a measurement principle based on an ultimate settlement notion would estimate Entity Z's liability to be CU450,000 in both in year 1 and year 2. Therefore users would not have the ability to assess the impact of the change in facts and circumstances. This information could be capable of making a difference.

Reliability

32. The *Framework* explains that information is reliable when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.[7]

33. The *Framework* also explains that to make economic decisions users require information about 'the ability of the entity to generate cash and cash equivalents *and of the timing and certainty of their generation*'.[8] The words emphasised in this quotation are particularly important because uncertainty about the timing and amount of cash flows is often associated with liabilities within the scope of IAS 37.

34. To be free from material error or bias information should be neutral and complete. Therefore an estimate should reflect all available information about the amount, timing and uncertainty of cash flows associated with a liability. Similarly, to faithfully represent the real-world uncertainties associated with liabilities within the scope of IAS 37 the estimate should reflect all available information about the amount, timing and uncertainty of cash flows. The staff's observations are not new. In *Understanding the Issues* the FASB

[7] *Framework*, paragraph 32. Reliability is not listed as a qualitative characteristic in the *Discussion Paper on Preliminary Views on an improved Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics of Decision-useful Financial Reporting Information*. This is because the Boards concluded that faithful representation encompasses all of the qualities of reliability – namely substance over form, neutrality, completeness and verifiability (paragraph BC 2.28).

[8] *Framework*, paragraphs 12 and 15 (emphasis added). The current requirement is also consistent paragraph OB3 in the Preliminary Views on an improved *Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics of Decision-useful Financial Reporting Information* which states '…financial reporting should provide information to help present and potential investors and creditors and others *to assess the amounts, timing, and uncertainty of the entity's future cash inflows and outflows* …' (emphasis added).

commented that 'the only way to communicate information about "amount, timing and uncertainty" in the carrying amount of an asset or liability is to incorporate all three in measurement …'[9]

Information about amount and timing

35. The examples in paragraphs 26 and 29 illustrate how a current settlement notion incorporates all available information about the amount required to settle a liability. A current settlement notion can also capture information about the timing of those future cash flows. Consider the following example[10]:

> Entity B operates an offshore oilfield. The licensing agreement for the oilfield requires Entity B to remove the oil rig at the end of production.
>
> At the balance sheet date management estimate that it is 25% likely that production will end in 5 years and it will cost CU500,000 to remove the oil rig; 60% likely that production will end in 10 years and it will cost CU600,000 to remove the oil rig; and 15% likely that production will end in 20 years and it will cost CU800,000 to remove the oil rig.
>
> The discount rate that reflects current market assessments of the time value of and the risks specific to the liability is 3%.
>
> The expected value of Entity B's liability is CU442,140.[11]

36. In this example, measuring Entity B's liability using a current settlement notion is neutral and complete because no information has been omitted. The estimate incorporates both the range of possible cash outflows and the timing of each cash flow.

[9] 'Expected Cash Flows' by Edward W. Trott and Wayne S. Upton, *Understanding the Issues*, May 2001, Volume 1, Series 1.
[10] For simplicity this example does not include a risk adjustment.
[11] The expected value calculation is:

Amount (CU)	**Probability**	**Probability weighted amount (CU)**	**Years @ 3%**	**Probability weighted discounted amount (CU)**
500,000	25%	125,000	5	107,826
600,000	60%	360,000	10	267,873
800,000	15%	120,000	20	66,441
		605,000		**442,140**

37. In contrast, a measurement principle based on an ultimate settlement notion only incorporates information about one possible amount (CU600,000). Discounting CU600,000 to present value (CU446,456) provides some additional information about the time value of money associated with that amount. But it would not incorporate *all* available information about the amount and timing of Entity B's liability at the balance sheet date.

Information about risks and uncertainties

38. A current settlement notion also captures the effects of risks and uncertainties associated with a liability in measurement. In other words, a current settlement notion faithfully represents the real-world economics of a liability even though an entity often could not or would not settle or transfer a liability within the scope of IAS 37 at the balance sheet date.

39. Continuing the example of Entity B: the amount Entity B expects to pay to settle its liability is CU600,000 in 10 years. But even if a market did exist, it is unlikely that Entity B could settle or transfer its obligation for CU600,000 (or even the discounted amount of CU446,456) at the balance sheet date. This is because it is reasonably likely that CU800,000 will be required to extinguish the obligation in 20 years time. A rational third party would demand a rate of return for assuming the risks and uncertainty associated with the amount and timing of cash flows required to extinguish the liability.

40. Based on the facts in this example, one might also argue that Entity B would not be willing to pay CU600,000 (or CU446,456) to settle or transfer its obligation at the balance sheet date. This is because there is a reasonable likelihood that Entity B could extinguish its obligation for less. Either way, a measurement principle based on the amount an entity expects to ultimately pay to settle a liability would not faithfully represent the real-world economic phenomenon associated with that liability.

Verifiability

41. The phrase 'can be depended upon by users' implies that reliable information should be verifiable. That is to say, different knowledgeable and independent observers would reach general consensus that the inputs into an expected value calculation are neutral, complete and faithfully representational. It is also

implies that the chosen estimation technique has been applied without material error or bias.[12] The result of verifying the inputs into and application of an estimate means that the output of the calculation can be depended upon by users.

42. Continuing the example of Entity B: the reliability of management's estimates of when production will end might be verified by comparing the age of the oil rig to its total expected useful life, or by reference to Entity B's five-year business plan (if such a plan exists). General consensus on the reliability of estimated costs to remove the oil rig might be reached by comparing the estimated cost to past experience and adjusting for inflation. And general consensus on the application of expected value can be achieved via recalculation.

Subjectivity

43. As noted by many respondents, the absence of a market necessitates the use of estimates to measure many liabilities within the scope of IAS 37. In some instances using judgment may have the potential to materially impact earnings from one period to the next. But adjusting a prior estimate of a liability without objective evidence to support the adjustment would not be consistent with the *Framework*.

44. Continuing the example of Entity Z in paragraph 29: Entity Z's estimate increased in year 2 as a result of new information emerging about the lawsuit. Entity Z's new estimate was reliable because it captured all available information about the liability at the balance sheet date and faithfully represented the change in available information during the reporting period.

45. But without new information, there would be no objective evidence to support any increase in Entity Z's estimate in year 2. To do so would not be neutral and would not faithfully represent events during the reporting period.

[12] IASB Discussion Paper *Preliminary Views on an improved Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics of Decision-useful Financial Reporting Information*, paragraph QC23.

Comparability

46. Paragraph 39 of the *Framework* explains that users of financial statements must be able to compare (i) the financial statements of an entity through time and (ii) the financial statements of different entities in order to evaluate their relative financial position and performance.[13]

Comparability through time

47. A current settlement notion achieves comparability from one period to the next because changes in available information are reported in the measurement of a liability immediately. Continuing the example of Entity Z: the financial position of Entity Z has worsened in year 2 because likelihood that it will have to pay CU600,000 or CU450,000 rather than CU350,000 or CU200,000 has increased from year 1 to year 2. The change is reflected in the expected value. Estimating the liability in this example using a measurement principle based on an ultimate settlement notion suggests that Entity Z's financial position is unchanged from one period to the next because the individual most likely outcome is CU450,000 in both years.

Comparability between different entities

48. A current settlement notion also achieves comparability between the financial statements of different two entities by ensuring relative uncertainty is reflected in the measurement of a liability. Consider the following example[14]:

> Entity X has a liability arising from a single product warranty. At the balance sheet date Entity X estimates there to be a 60% chance that a claim will be made (costing Entity X CU1,000) and a 40% chance that a no claim will be made (costing Entity X CUnil).
>
> Entity Y also has a liability arising from a single product warranty. At the balance sheet date Entity Y estimates there to be a 90% chance that a claim will be made (costing Entity Y CU1,000) and a 10% chance that no claim

[13] Comparability is also a qualitative characteristic include in the IASB Discussion Paper on *Preliminary Views on an improved Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics of Decision-useful Financial Reporting Information*, paragraphs QC35 – QC38.
[14] For simplicity this example does not include a risk adjustment or discount the liability to present value.

will be made (costing Entity Y CUnil).

49. Applying a measurement principle based on an ultimate settlement notion, Entity X and Entity Y would both recognise a liability of CU1,000. But this outcome suggests that the financial position of the two entities is the same. This is clearly not the case - Entity Y is 30% more likely incur a cash outflow than Entity X. Applying a measurement principle based on a current settlement notion would reflect the difference in uncertainty between Entity X and Entity Y allowing users to more fairly assess the financial position of each entity at the balance sheet date.

Understandability

50. The *Framework* explains that users of financial statements are assumed to have a reasonable knowledge of business and economic activities and accounting and have a willingness to study the information with reasonable diligence. Therefore relevant information about complex matters should not be excluded merely on the grounds that it may be too difficult for certain users to understand.[15]

51. Based on this guidance staff thinks it reasonable to assume that informed users would understand the results of a measurement principle based a current settlement notion.

52. In particular, the staff thinks it is reasonable to assume that informed users would understand that the proposed measurement principle does not purport to predict the ultimate cash outflow required to settle an obligation. Therefore informed users would also understand that a difference between the output of an expected cash flow approach at the balance sheet date and the actual cash outflow to extinguish the liability in a subsequent reporting period does not mean an entity's earlier estimate of a liability was 'wrong'.

53. These assumptions are supported by the views articulated by some users. For example, in a letter to the FASB, [an analyst] commented that standards that use the most likely outcome as an estimation technique are 'outdated and are no longer consistent with the way managements or investors make decisions

[15] *Framework*, paragraph 25 and the *Discussion Paper on Preliminary Views on an improved Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics of Decision-useful Financial Reporting Information*, paragraph QC39.

… investors have become more sophisticated about stochastic processes and are able to understand the significance of numbers reported in this manner. … In other words, we recognise that a liability measured on the basis of expected cash flows will not likely be the amount at which an obligation is ultimately settled.'[16]

Accuracy

54. Accuracy (ie the proximity of an estimate to the actual cash outflow required to settle a liability) is <u>not</u> a qualitative characteristic in the *Framework*.

55. Moreover, a measurement principle based on an ultimate settlement notion does not guarantee a more 'accurate' estimate. Continuing the example of Entity X in paragraph 48: at the balance sheet date, an ultimate settlement notion is only more 'accurate' than a current settlement notion if a claim is made under the product warranty. If no claim is made, an expected value of CU600 is closer to the ultimate cash flow of CU nil than CU1,000.

56. Moreover, an alternative view is that using a current settlement notion is no harder than estimating the amount an entity expects to pay to settle its obligation. This is because identifying and justifying a range of possible outcomes is easier than identifying and justifying a single point estimate. Proponents of this view would not suggest that expected value requires the use of complex models, capturing all possible outcomes. Rather, they would simply note that establishing and verifying a reasonably accurate range in which the amount required to settle a liability falls is easier than establishing and verifying *the* single most likely amount required to settle a liability.

[16] Responding to the FASB Invitation to Comment on *Selected Issues Relating to Assets and Liabilities with Uncertainties*