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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: Is more guidance on the IAS 37 measurement principle required? (Agenda Paper 8D)**

INTRODUCTION

1. IAS 37 provides high-level guidance on the core components of an expected value calculation: probability-weighted cash flows, discount rates and risk adjustments.[1] But the Standard does not provide detailed application guidance on how develop an estimate using expected value.

2. The guidance in IAS 37 has been carried forward to the ED largely unchanged (some editorial amendments were made to improve the clarity of the guidance and an example was added to the illustrative example accompanying the ED). Nonetheless, many respondents ask the Board to further clarify aspects of the guidance in the ED. Others ask the Board to provide additional guidance, covering topics not included in the ED.

3. In agenda paper 8A the staff recommends that the Board affirm its previous decision to limit the scope of its amendments to measurement - emphasising the existing IAS 37 measurement principle and clarifying aspects of the

[1] This paper 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.

accompanying guidance only.[2] In light of this recommendation, this paper begins by considering whether more guidance is consistent with the limited scope of amendments to measurement in this project. If so, the paper then goes on to identify which topics require further clarification and/or additional guidance.

4. Exceptions to the proposed measurement principle, including an assessment of whether all liabilities within the scope of IAS 37 are capable of reliable measurement, will be separately considered in October.

5. After the summary of recommendations the remainder of this paper is structured as follows:

Section A: Is more guidance required? [paragraphs 7-18]

Section B: Further clarification of existing guidance [paragraphs 19-29]

Section C: Providing additional guidance [paragraphs 30-41]

Section D: Objections to the existing guidance [paragraphs 42-44]

SUMMARY OF RECOMMENDATIONS

6. The staff recommends that:

   (a) more guidance on how to use expected value to measure liabilities within the scope of IAS 37 should be included in any final Standard; and

   (b) further amendments should be limited to clarifying the guidance in the ED and explaining the attributes of estimates developed using expected value.

A. IS MORE GUIDANCE REQUIRED?

7. In light of the recommendation to limit the scope of amendments to measurement in this project, this section considers whether further clarifying

[2] This paper is based on the working assumption that the Board agrees with the staff recommendation and therefore the scope of any amendments to the existing IAS 37 measurement principle and accompanying guidance should be limited.

or adding to the ED's guidance is appropriate. The staff has analysed the need for more guidance based on the following questions:

- Is guidance already available?
- Would failing to provide more guidance decrease the quality of financial information?
- Would more guidance alleviate concerns about other amendments proposed in the ED?
- Is this a pervasive issue?

Available guidance

IFRS literature

8. As noted in the introduction, IAS 37 provides high-level guidance on how to develop an estimate using expected value in the context of IAS 37. The ED proposes limited amendments to clarify and add to this guidance. Other standards also provide guidance on how to develop an estimate using expected value. For example, Appendix A of IAS 36 *Impairment of Assets* explains the attributes of an expected cash flow approach and discount rates. However, the guidance provided in other standards does not always address IAS 37-specific issues.

9. The Board is currently discussing measurement issues in other projects such as insurance and fair value measurement. These discussions may result in measurement guidance which could also be used in the context of IAS 37. But again it is unlikely that this guidance will be tailored to address IAS 37-specific issues. Also no authoritative guidance (ie a standard) is expected to result from these projects in the short-term.

Other accounting literature

10. In the absence of IFRS literature, IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* permits an entity to refer to other sources. US GAAP is one source of guidance on how to estimate liabilities using expected value. For example, Concepts Statement No. 7 *Using Cash Flow*

Information and Present Value in Accounting Measurements includes an example illustrating how to use expected value to estimate liabilities with non-contractual cash flows (a particular area of concern expressed in the IAS 37 comment letters).[3] Similarly, appendix C of SFAS 143 *Conditional Asset Retirement Obligations* includes illustrative examples on how to estimate asset retirement obligations using expected value.

Diversity in practice

11. The existence of liability-specific guidance in IFRS and other accounting literature is one argument against providing more guidance in this project. But the guidance in IAS 37 and other standards has not proven sufficient in the past. That is to say, the existing guidance has not dispelled mis-conceptions about using expected value to estimate liabilities. The comment letters indicate that many respondents' consider that the existing guidance leaves many questions unanswered. [Sentence omitted from observer note]

12. The limited amendments proposed in the ED do not aim to answer these questions. But failing to consider these issues may result in the development of alternative and inconsistent application guidance, reducing the usefulness of financial information.

Decreased quality of financial information

13. The staff believes that failing to provide more guidance on how to use expected value to develop estimates of liabilities within the scope of IAS 37 may decrease the quality of financial information. The comment letters indicate that some respondents are not comfortable with the objective and attributes of an expected value calculation. Therefore there is a risk that important information will be omitted from an expected value calculation. This outcome would reduce the relevance and reliability of an entity's estimate.

14. Secondly, failing to provide more guidance is likely to result mis-application and inconsistent application of the ED's measurement principle. This outcome would reduce users' ability to compare an entity's results from one period to the next and compare an entity's results with other similar entities.

[3] See paragraphs 75-88 and appendix A of Concepts Statement No. 7.

Other amendments proposed in the ED

15. More guidance on how to develop an estimate of a liability using expected value may alleviate concerns about other amendments proposed in the ED. For example, some respondents accept the theory underpinning the proposal to omit the probability recognition criterion (because uncertainty about the outflow of resources required to settle a liability is reflected in measurement). But these respondents continue to express concern about the practical feasibility of the proposal. That is to say, respondents are not sure they can apply the theory in practice. More guidance on how to develop estimates using expected value might also alleviate concerns about omitting the probability recognition criterion.

Pervasiveness

16. Requests for more guidance are not limited to one geographic region, representative body or industry, indicating that this is a pervasive issue.

Conclusion

17. Based on the analysis above, the staff believes that more guidance is required to ensure that any final standard can be consistently applied in practice. Therefore the remainder of this paper considers how to balance the need for more guidance with the recommendation to limit the scope of proposed amendments to the IAS 37 measurement principle in this project.

18. **Does the Board agree that more guidance on how to use expected value to measure liabilities within the scope of IAS 37 (further clarification and/or additional guidance) should be included in any final Standard?**

B. FURTHER CLARIFICATION OF EXISTING GUIDANCE

19. Clarifying the guidance in the ED (as opposed to adding new guidance) may be viewed as continuing the Board's initiative to clarify the existing IAS 37 measurement guidance. Clarifying the ED's guidance is also consistent with the staff recommendation in agenda paper 8A. Therefore this section of the paper focuses on how to balance the extent of further clarifications with the limited scope of amendments to the measurement guidance in this project.

Extent of further clarifications

20. The ED currently describes the attributes of information used to estimate a liability using expected value. For example, paragraph 38 explains that the discount rate used should reflect current market assessments of the time value of money, but should be adjusted to also reflect risks specific to the liability. The ED does not specify which discount rate should be used. Nor does the ED specify how to adjust a current market rate to reflect risks specific to the liability.

21. The staff believes that limiting the extent of further clarifications to explaining the attributes of information used to estimate a liability would be consistent with the scope of amendments to measurement guidance in this project. The staff does not believe that detailed application guidance (similar to that provided in IAS 39 *Financial liabilities: Recognition and Measurement* or Appendix B of IFRS 2 *Share-based Payments* for example) would be appropriate. Detailed application guidance is beyond the level of guidance already provided in IAS 37 and the ED. Therefore detailed application guidance would be inconsistent with the scope of amendments to measurement guidance in this project.

Focus of further clarifications

22. The staff also believes it would be appropriate limit further amendments to clarifying aspects of the ED's guidance which continue to cause confusion. The staff does not believe it would be appropriate to re-write all sections of the measurement guidance in the ED.

23. The staff has reviewed the comment letters to identify all requests for further clarification of the guidance in the ED. The staff has also identified potential aspects of the ED's guidance for further clarification through internal and external discussions. [Sentence omitted from observer note]

24. Based on the recommendation above, the staff recommends further clarifying the following points:

(a) the complexity of the model required to complete an expected value calculation will vary depending on the nature of the liability being estimated;

(b) the attributes of a risk adjustment;

(c) which cash flows should be used in an expected value calculation (entity-specific or market-based); and

(d) when an expected change in law is a future event which should be reflected in the range of possible cash flows, and when an expected change in law is a future event which changes the nature of the liability.

25. The staff notes that further discussion of points (c) and (d) may be required before the ED's guidance can be clarified. If the Board agrees with the recommendation in this paper, the staff plans to present an analysis of these points for discussion at a future Board meeting.

26. The staff does not believe it is appropriate to provide guidance on the following points:

(e) where to source probability-weighted cash flows in the absence of an observable market;

(f) how to calculate a risk adjustment; and

(g) how much detail is required to complete an expected value calculation.

Other reasons for limiting the extent of further clarification

27. Scope underpins the staff recommendation to limit the extent and focus of further clarifications to the guidance in the ED. But there are also other reasons to limit the extent and focus of further clarifications to the guidance in the ED. These reasons are:

- *One size does not fit all*. The potential sources of information and type of model required to estimate a liability using expected value will differ depending on the nature of the liability being estimated. In contrast, clarifying the attributes of information used to estimate a liability using expected value permits preparers and users of financial statements to consider the facts and circumstances specific to each liability.

- *Feasibility*. It is not feasible for the Board to provide detailed guidance on how to use expected value to estimate every liability in all jurisdictions. Different legal and economic environments may mean that information about similar liabilities may come from different sources.

- *Outdated techniques*. Specifying a particular method to be used to estimate a liability using expected value (eg how to calculate a risk adjustment) might prevent an entity using more sophisticated techniques which become available in the future. In contrast, guidance clarifying the objective and attributes of an estimate is less likely to become outdated.

- *Principles not rules*. Explaining the attributes of an estimate developed using expected value is consistent with a principles-based approach to standard-setting. Detailed guidance may be perceived as a list of rules.

- *Understandability*. High-level guidance is likely to meet the needs of reasonably informed users of accounting standards in a majority of cases. Detailed guidance might also provide guidance in more extreme cases. But the increased level of detail needed might obscure the more fundamental messages.

28. One advantage of detailed guidance may be less need for judgment, reducing the risk of inconsistent application. However, the staff does not believe that this argument is sufficiently persuasive to override the arguments outlined above.

29. **Does the Board agree that further clarifications should be limited to explaining the attributes of information used to estimate a liability using expected value, focusing on the aspects of existing guidance which continue to cause confusion?**

C. PROVIDING ADDITIONAL GUIDANCE

30. In addition to clarifying aspects of the existing guidance, some respondents ask the Board to provide guidance on topics not covered in the ED. [Remainder of paragraph omitted from observer note]

31. Providing additional guidance on topics not covered by the ED is inconsistent with the limited scope of amendments to measurement in this project. It is also inconsistent with the staff recommendation in section B of this paper: focus on clarifying the guidance in the ED and limit amendments to explaining the attributes of estimates developed using expected value.

32. Therefore this section of the paper considers whether it is necessary to extend the scope of amendments to the measurement guidance to include topics not covered in the ED. In particular the staff considers whether failing to provide additional guidance on these topics would result in an inability develop an estimate using expected value (thereby failing to meet the measurement principle).

Existing guidance

33. Arguably [existing guidance] implicitly addresses the additional topics identified. Therefore an entity could estimate a liability using expected value without additional guidance. [Remainder of paragraph omitted from observer note]

34. [Paragraph omitted from observer note]

Past discussions

35. It is also possible to argue that extending the scope of this project is not necessary because these topics have already been debated, or are being debated, in the context of other projects. These topics are not IAS37-specific therefore an entity could estimate a liability using expected value without additional guidance.

36. [Paragraph omitted from observer note]

37. [Paragraph omitted from observer note]

Worst case scenarios

38. Failing to provide additional guidance increases the risk that estimates of similar liabilities will be inconsistent [remainder of sentence omitted from observer note]. But failing to provide additional guidance on these topics would not prevent an entity using the core components of expected value to estimate a liability.

39. [Paragraph omitted from observer notes]

Conclusion

40. Based on the analysis above, the staff does not believe it is necessary to extend the scope of amendments to the measurement guidance to include additional topics not covered in the ED. The staff acknowledges that this conclusion increases the risk of inconsistent estimates of similar liabilities.

41. **Does the Board agree?**

D. OBJECTIONS TO THE EXISTING GUIDANCE

42. Finally, the comment letters indicate that a small number of respondents object to specific aspects of the measurement guidance already provided in the ED. These objections are:

    (a) including a risk margin in the measurement of a liability;

    (b) reflecting changes in discount rates in the subsequent measurement of a liability; and

    (c) excluding the effect of changes in legislation (even when a change is highly probable) until the law is substantively enacted in the measurement of a liability.

43. The staff has included these objections in this paper for completeness. However, the staff does not propose discussing these objections as part of the redeliberation process. This is because the conceptual arguments refuting objections (a) and (b) are included in agenda paper 8C. Objection (c) was

addressed earlier in the redelibertion process.[4] Moreover, concerns about the practical difficulties of including a risk margin in the measurement of a liability are addressed in section B of this paper.

44. **Does the Board agree?**

APPENDIX A

[Appendix omitted from observer note]

[4] See appendix A, agenda paper 10D, presented at the May 2006 Board meeting.