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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting:	**Thursday 13 December, London**
Project:	**Liabilities — amendments to IAS 37**
Subject:	**Measurement of liabilities (Agenda Paper 8)**

PAPER 8 — OVERVIEW OF PAPERS

Background

1 The main aim of the liabilities project is to improve the requirements in IAS 37 relating to *identification* and *recognition* of liabilities. When developing the Exposure Draft[1], the Board decided that the scope of the project should not be expanded to include a fundamental review of the existing *measurement* requirements.

2 However, acknowledging ambiguities in those requirements, the Board took the opportunity to propose limited amendments to clarify that:

a) the objective is to measure the liability at its *current* settlement/transfer amount, ie the amount that the entity would rationally pay to settle the obligation or transfer it to a third party *on the measurement date*; and

b) an 'expected cash flow' approach is an appropriate way of estimating this amount, even for single obligations.

3 In September and October 2006, the Board discussed comments received on the measurement proposals. The Board reaffirmed its decision not to undertake a fundamental review of the measurement requirements. It also rejected commentators' suggestions that the proposals would change rather than clarify the existing requirements of IAS 37 and would lead to liability measurements that are neither relevant nor reliable.

[1] Exposure Draft of proposed amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and IAS 19 *Employee Benefits*, published June 2005.

4 However, in the light of comments received, the Board decided to:

a) explore whether it could remove remaining ambiguity, by specifying as the measurement objective *either* current settlement amount *or* current transfer amount, not both;

b) explain more fully in the Basis for Conclusions why current settlement/transfer amount gives users useful information about liabilities within the scope of IAS 37; and

c) add more high-level guidance on how to estimate the current settlement/transfer amount of a liability using an expected cash flow approach.

Aim of this meeting

5 Papers 8B and 8C for this meeting follow up on the first two of three matters, taking into account additional feedback received from participants at round-table meetings held in November and December 2006. (The third matter will be addressed at a future meeting.)

6 Paper 8A first considers how to address the other main concern raised by the round-table participants—that the proposed amendments change rather than clarify the requirements of IAS 37.

Recap of the proposals

7 It is nearly a year since the Board last discussed the Exposure Draft proposals on measurement. So Paper 8A starts with a brief reminder of the background to the proposals and decisions already taken in the light of comments received.

PAPER 8A — CLARIFICATION OR CHANGE

Purpose of paper

1 Paper 8A considers how the Board should address concerns that it is changing, not clarifying, the measurement requirements in IAS 37.

Background

Existing requirements of IAS 37

2 The existing measurement requirement is set out in paragraph 36 of IAS 37:

> **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.**

3 Paragraph 37 then clarifies that this amount is based on a *current* settlement notion:

> The best estimate of the expenditure required to settle the present obligation is the amount that the 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)

4 However other requirements and guidance imply that the measurement objective in paragraph 36 is based on an *ultimate* settlement notion, ie the future costs that the entity will incur when it is time to settle the obligation. For example, paragraph 45 states that:

> **Where the effect of the time value of money is material, the amount of a provision shall be the present value of the expenditures expected to be required to settle the obligation.**

5 Paragraphs 39 and 40 provide guidance on how to estimate the liability if there is uncertainty about the outcome:

a) paragraph 39 gives guidance for large populations of items:

> Where the provision being measured involves a large population of items, the obligation is estimated by weighting all possible outcomes by their associated probabilities. The name for this statistical method is 'expected value'.

b) paragraph 40 addresses single obligations:

> 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 will be a higher or lower amount. For example, if an entity has to rectify a serious fault in a major plant that it has constructed for a customer, the individual most likely outcome may be for the repair to succeed at the first attempt at a cost of 1,000, but a provision for a larger amount is made if there is a significant chance that further attempts will be necessary.

6 This last paragraph could be interpreted in different ways. The first sentence, *read in isolation* could be interpreted as endorsing a view that the 'best estimate' of a single obligation may be its individual most likely outcome, not its expected value. However, the whole paragraph, *read in its entirety*, appears to endorse the individual most likely outcome only when it is the centre of the range of possible outcomes and hence may approximate to expected value.

Changes proposed in Exposure Draft

7 When developing the Exposure Draft, the Board acknowledged the ambiguities in the existing requirements. It decided to clarify the requirements by:

a) removing the term 'best estimate' and replacing it with the definition that followed it to clarify that the measurement objective is a *current* settlement/transfer amount;

b) redrafting other guidance on measurement to remove any suggestions that the measurement objective might be based on an *ultimate* settlement notion; and

c) explaining that an expected cash flow approach is an appropriate way of estimating the current settlement/transfer amount for both large populations of items *and* single obligations.

8 Therefore, the Exposure draft proposed that:

> 29 **An entity shall measure a non-financial liability at the amount that it would rationally pay to settle the present obligation or to transfer it to a third party on the balance sheet date.**
>
> 30 In some cases, contractual or other market evidence can be used to determine the amount that would be required to settle or transfer the obligation on the balance sheet date. However, in many cases, observable market evidence … will not exist and the amount must be estimated.
>
> 31 The basis of estimating many non-financial liabilities will be an expected cash flow approach, in which multiple cash flow scenarios that reflect the range of possible outcomes are weighted by their associated probabilities. An expected cash flow approach is an appropriate basis for measuring both liabilities for a class of similar obligations and liabilities for single obligations. This is because it is likely to be the basis of the amount that an entity would rationally pay to settle the obligation(s) or to transfer the obligation(s) to a third party on the balance sheet date. In contrast, a liability for a single obligation measured at its most likely outcome would not necessarily represent the amount that the entity would rationally pay to settle or to transfer the obligation on the balance sheet date.

Feedback from comment letters and round-table meetings

Comment letters

9 Many of those responding to the Exposure Draft thought that its proposals significantly changed, rather than clarified the existing requirements in IAS 37. They focused on the existing requirement to measure liabilities at the ‘best estimate of the expenditure required to settle the present obligation’ without acknowledging that this amount is explicitly defined as ‘the amount that the entity would rationally pay to settle the obligation at the balance sheet date or to transfer it to a third party at that time’. Some clearly thought that at present IAS 37 permits individual obligations to be measured at their most likely outcome. They did not acknowledge the subsequent clarification that ‘where other possible outcomes are either mostly higher or mostly lower than the most likely outcome, the best estimate will be a higher or lower amount’.

Round-table meetings

10 In the background materials prepared for the round-table meetings, the Board attempted to explain why it believes that it is clarifying rather than changing the requirements. However, most participants in the meetings were not persuaded.

11 Few participants objected to the statement that the proposed measurement objective is derived from the existing measurement guidance in IAS 37. And most agreed that IAS 37 requires an entity to measure the liability that exists at the end of the reporting period, not the liability that may exist in future. But they did not agree that the phrase ‘best estimate of the expenditure required to settle the present obligation at the balance sheet date’ requires the entity to estimate the amount that it would pay *on that date* to settle the obligation immediately. They argued that it is accepted practice for this phrase to be interpreted to mean the present value of the expenditure required when the liability is ultimately settled.

12 A minority of participants accepted that the existing standard could be interpreted in more than one way, but noted that general practice does not support Board's interpretation.

13 Participants' recommendations on how the Board should proceed were mixed. Some favoured reverting to the existing requirements of IAS 37. Some suggested that the Board should fundamentally review the measurement requirements of IAS 37. Others recommended looking to general practice to resolve the ambiguity associated with 'best estimate' – that is, by clearly stating that the IAS 37 measurement objective is the costs incurred when the obligation is ultimately settled.

Subsequent Board discussions

14 In January 2007, when considering a summary of the feedback from the round-table meetings, the Board again considered the possibility of expanding the scope of the project to make more fundamental changes to the measurement requirements in IAS 37. Only by making such changes would the Board be able to replace the existing requirements with a single clear measurement objective, such as fair value.

15 However, the Board (some members more reluctantly than others) decided not to expand the project in this way. Board members accepted that:

a) a clear measurement objective, such as fair value, is desirable but was never the main focus of this project;

b) the definition of fair value is still being developed as part of another Board project. It is not yet possible to compare fair value with other possible measurement objectives, or the existing requirements of IAS 37; and

c) any fundamental changes to the measurement objective would take time to develop and require exposure. This process would significantly delay the issue of the revised standard. The revised standard should be published as soon as possible to improve identification and recognition of liabilities, reduce differences between IAS 37 and US GAAP and eliminate differences between IAS 37 and the initial recognition requirements of IFRS 3 *Business Combinations.*

16 The papers for this meeting do not re-open this issue because the arguments above still apply and the Board is now even closer to issuing a final standard—expanding the scope of the project could have even more impact on timing.

Staff analysis

17 In the staff's opinion, the feedback from round-table participants confirms that the existing requirements of IAS 37 are being misinterpreted and hence that it is important for them to be clarified, as proposed in the Exposure Draft.

18 The Board would however have to consider how to counter the view that it is changing not clarifying the requirements.

19 The staff think that the Board is not imposing new measurement requirements. Only people who have read the existing requirements selectively could have interpreted them as requiring liabilities to be measured on the basis of the ultimate future costs and, for single obligations, the individual most likely outcome. In the staff's view, the Board can counter the arguments that it is imposing new requirements by highlighting relevant extracts of the existing text and demonstrating that they form the basis of the revised requirements. This was not done in any great detail in the Basis for Conclusions accompanying the Exposure Draft.

20 A slightly different concern expressed in the comment letters and round-table meetings was that the Board is narrowing the range of acceptable interpretations of the existing requirements, but *not* selecting the most suitable interpretation. The staff believe that this concern will be addressed by explaining why the Board

believes that a current settlement or transfer price is a relevant and reliable measure of liabilities within the scope of IAS 37 — see Paper 8C.

Staff recommendations

21 The staff will recommend that the Basis for Conclusions in the Exposure Draft is revised to include extracts from the existing IAS 37 that demonstrate that the new requirements are derived from the previous ones.

22 [This paragraph, which proposes text for consideration by the Board, has been omitted from the observer note.]

Questions for the Board

23 The staff has proposed that concerns the existing requirements are being changed, not clarified, would be adequately addressed by greater explanation in the Basis for Conclusions. Board members will be asked:

a) whether they agree, and if they do

b) whether they are happy with the text proposed by the staff.

PAPER 8B — SETTLEMENT OR TRANSFER AMOUNT

Purpose of paper

1 Paper 8B considers whether the Board should remove one or other of the two measurement objectives (ie settlement amount or transfer amount) from the proposed measurement requirements.

Background

Exposure draft proposal

2 The Exposure Draft proposed that:

> 29 An entity shall measure a non-financial liability at the amount that it would rationally pay *to settle the present obligation or to transfer it to a third party* on the balance sheet date. (Emphasis added)

Comment letter feedback

3 Some commentators criticised this proposal because it did not fully achieve the Board's stated objective of removing ambiguities in the existing requirements. It was not clear:

- whether there was a difference between the amount that would be required to settle an obligation and the amount that would be required to transfer it to a third party; and
- if there were a difference, what that difference would be and whether entities had a free choice between the two measurement objectives.

Subsequent Board discussions

4 In the light of these comments, the Board considered whether it should eliminate one or other of 'amount to settle' or 'amount to transfer'[2]. As part of this discussion, it considered whether there would be any difference between the two amounts.

5 The Board did not conclude on whether would be a difference. Its discussion focused on the word 'rationally':

- One view was that there would be no difference between the two measures. The word 'rationally' implied that an entity could assume that all parties had the same information about the liability and would act rationally upon that information. Rationally, the entity would pay no more to the counterparty to settle the liability than it would need to pay a third party to assume the liability; rationally, the counterparty would not accept less. Hence IAS 37 did not permit a choice.
- The other view was that there could be a difference between the two amounts, perhaps because of information asymmetry or differences between the counterparty and third party's attitude to risk. The word 'rationally' implied only that an entity should choose the lower of 'amount to settle' and 'amount to transfer'.

6 Without resolving this issue, the Board expressed a preference for removing one of the options. It observed that 'amount to transfer' was a clear term, which was generally understood to be a current measure that gave precedence to market information over entity-specific information. However, the Board was concerned that retaining only 'amount to transfer' would establish fair value as the IAS 37 measurement objective—an outcome at odds with its previous decisions. It further observed that 'amount to settle' could be regarded as a broader term and interpreted in different ways.

[2] Agenda Paper 8, October 2006

7 The Board did not reach a conclusion on whether to remove one or other of the options. However, following a staff recommendation, it agreed that the staff should explore further an example using the following draft guidelines:

- the measurement objective is the amount an entity would rationally pay to settle an obligation on the balance sheet date—a current settlement notion. An entity may settle a liability on the balance sheet date in two ways: by paying the counterparty to release the entity from its obligation; or paying a third party to assume its obligation.
- an entity should give precedence to market information when available.

Round-table meetings

8 When asked for their views, most participants in the round-table meetings thought that estimates of the ‘amount to settle’ and ‘amount to transfer’ would be different, and therefore that the Exposure Draft did not resolve all ambiguities in the existing measurement requirements.

9 Some participants thought that ‘amount to transfer’ would typically be higher than ‘amount to settle’ because an external party would require a profit margin and compensation for assuming the unknown, in addition to the risks inherent in the liability itself. They thought that ‘amount to transfer’ could be lower than ‘amount to settle’ if the external party had specialist knowledge about a particular type of liability and therefore could discharge that liability more efficiently than the entity itself.

10 A majority also thought that the word ‘rationally’ implied that management intent was the appropriate basis for choosing between ‘amount to settle’ and ‘amount to transfer’. This was because using management intent would more closely align the measure of a liability with the entity’s expected cash flows.

Whether to remove one of the options

Staff analysis

11 The views reported above suggest that there is a need for more clarity about the measurement objective—ideally one or other of the options should be eliminated or the differences between the two options and the circumstances in which each could be applied should be explained.

12 However, it could be argued that the Board should not try to resolve the matter in this project:

(a) it would significantly delay the project. The Board will be comparing transfer and settlement prices as part of its fair value measurement project. This work would need to be completed before any decision was taken regarding removal of one of the two measurement objectives from IAS 37. Any change may then also require further consultation;

(b) the marginal benefits would not be great enough to merit the delay. By clarifying that the measurement requirements are based on a current rather than ultimate settlement notion, the revised standard will be a major step forward even without resolving this matter; and

(c) in the meantime, the (perceived) choice will not cause significant divergence in practice:

(i) the basic inputs to the calculations—the expected cash flows, the risk in these flows and the time value of money—are similar for both calculations. The calculations are inherently subjective and measurements are subject to a degree of variation that will not be significantly increased by having two slightly different measurement objectives; and

(ii) the Business Combinations project team conducted a case study in which participants were asked to measure the fair value of contingent liability using two different definitions of fair value—the IFRS 3 definition (the amount for which a liability could be settled) and the FASB Statement No. 157 definition (the price that would be paid to transfer a liability). Participants arrived at a range of different answers, but each arrived at the same answer applying the ‘amount to settle’ definition as they did applying the ‘price to transfer’ definition.[3]

Staff recommendation and question for the Board

13 For the reasons given in paragraph 12, the staff will recommend that the Board does not seek to eliminate either ‘amount to settle’ or ‘amount to transfer’ as part of this project.

Board members will be asked whether they agree.

If retaining both options, whether to refine the wording

14 If the Board decides to retain both ‘amount to settle’ and ‘amount to transfer’, it could:

(a) broadly retain the wording proposed in the Exposure Draft, perhaps clarifying that settlement refers to settlement with the counterparty:

> An entity shall measure a liability at the amount that it would rationally pay to settle the present obligation [with the counterparty] or to transfer it to a third party on the ~~balance sheet~~ measurement date.

or

[3] Paragraph 12, Paper 2A, April 2007 Board meeting.

(b) as previously proposed by staff (paragraph 7), refine the wording to emphasise the common features of both measurement objectives. Possible wording would be:

> An entity shall measure a liability at the amount that it would rationally pay to ~~settle~~ extinguish the present obligation ~~or to transfer it to a third party~~ on the ~~balance sheet~~ measurement date. An entity could extinguish an obligation by settling it with the counterparty or transferring it to a third party.

The staff had previously proposed to use the word 'settle' instead of 'extinguish'. However, 'settle' is used in other accounting literature, most notably FASB Statement No. 157, to refer only to circumstances in which a liability is settled with the counterparty[4]. The term 'extinguish' is used in IAS 39 to encompass both settlement with the counterparty and transfer to a third party (with legal release from the counterparty).

15 An advantage of option (a) is that the wording remains very similar to that in the existing IAS 37. The similarity makes it easier for the Board to demonstrate that is not changing the measurement requirements.

16 An advantage of (b), refining the wording, is that, by emphasising the common features of the two measurement objectives, the Board will avoid an impression that there are two significantly different alternatives permitted for liability measurement.

Staff recommendations and question for the Board

17 The staff will recommend option (a), ie broadly retaining the Exposure Draft wording, as set out in paragraph 14(a).

Board members will be asked whether they agree.

4 Paragraph 15 of Statement 157 states that: "A fair value measurement assumes that the liability is transferred to a market participant at the measurement date *(the liability continues; it is not settled)* and that the non-performance risk relating to that liability is the same before and after its transfer. (Emphasis added.)

PAPER 8C —
RATIONALE FOR CURRENT SETTLEMENT/TRANSFER AMOUNT

Purpose of this paper

1 In September 2006, the Board asked the staff to add text to the Basis for Conclusions to explain why it believes that proposed measurement requirements will give users useful information about liabilities in the scope of IAS 37.

2 Paper 8C presents draft text for the Board's approval.

Background

3 Many of those commenting on the Exposure Draft thought that the amount that an entity would rationally pay to settle an obligation or transfer it to a third party at the measurement date is not a decision-useful measure of liabilities within the scope of IAS 37. They argued that:

c) it is not a relevant measure, because such liabilities are typically not settled early or transferred to third parties. The 'real world' liability is best represented by the costs expected to be incurred when the liability is settled; and

d) in the absence of a market for many liabilities with the scope of IAS 37, estimates of the prices at which they would be settled or transferred are unreliable.

4 The Board addressed this concern by assessing the proposed measurement requirement against the qualitative characteristics in the *Framework*[5].

5 Based on that analysis, the Board reaffirmed its view that the current settlement/transfer amount does contain useful information. It directed the staff to draft text that could be added to the Basis for Conclusions to explain its views. The Board asked the staff to emphasise that:

a) many equate reliability with the proximity of the estimate of the liability to the actual cash flow subsequently required to settle it. But a difference between the measure of a liability at one date and the actual cash flow required to settle it at a later date does not mean that the measure was 'wrong'.

b) 'reliable measurement' refers to the reliability of the inputs used to estimate a liability and application of the chosen estimation technique.

c) the subjectivity required to measure the current settlement/transfer amount of a liability is no greater than the subjectivity required to estimate the individual most likely costs that will be incurred in future to settle that liability.

d) an expected cash flow approach incorporates in the estimate of a liability *all* available information about that liability. In contrast, measurement at the most likely outcome ignores some of that information.

6 The Board also decided to include an example illustrating these points in the background materials that it prepared for the round-table meetings.

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5 Agenda Paper 8C, September 2006.

7 Some participants in the round-table meetings found the example useful for helping them to understand the Board's preference for expected cash flow approaches. However, others did not. Consistent with their preference for a measurement basis that seeks to estimate the future cash flows required to settle the liability, many of these participants favoured using individual most likely outcome to estimate all liabilities within the scope of IAS 37. Some went on to argue that expected value is a practical/efficient way to estimate the individual most likely outcome for a large population of similar liabilities.

Staff analysis

8 Participants in the round-table meetings did not put forward new arguments to challenge the Board's earlier conclusion that a current settlement/transfer amount gives users useful information about liabilities within the scope of IAS 37. However, they demonstrated that opinion remains divided, supporting the Board's previous decision to explain its views in the Basis for Conclusions.

Staff recommendation

9 [This paragraph, which proposes text for consideration by the Board, has been omitted from the observer note.]

Questions for the Board

10 Board members will be asked whether they agree that the constituent concerns reported in this paper should be addressed by adding text to the Basis for Conclusions.

11 If they agree, Board members will be asked whether they are happy with draft text proposed by the staff.