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International
Accounting Standards
Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting:	**23 January 2007, London**
Project:	**Business Combinations II**
Subject:	**Contingencies (Agenda paper 2B)**

This agenda paper has been prepared for the IASB only. Because the FASB does not have a separate project on contingencies on its agenda, this topic is being considered separately by the Boards.

Appendices A and B of this paper are provided for reference purposes only.

INTRODUCTION

1. Concurrent with the issuance of the Business Combinations Exposure Draft (BC ED), the IASB issued an Exposure Draft of Proposed Amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* (IAS 37 ED). The original plan was to address the accounting for contingencies comprehensively in the IAS 37 project and to align the effective dates of the business combinations standard and the revised IAS 37. (Note: This paper uses the term *contingencies* as a short-hand way to describe assets or liabilities in which the amount of the future economic benefits embodied in the asset or

required to settle the liability are contingent (or conditional) on the occurrence or non-occurrence of one or more uncertain future events.)

2. The current IAS 37 project plan envisages that a final standard on liabilities will not be issued until the second quarter of 2008. The *earliest* that the revised IAS 37 could be effective would be July 2009, after the business combinations standard will likely be effective (January 2009). Therefore the Board needs to decide how to address contingencies in the business combinations project between when the business combinations standard is issued and when the revised IAS 37 is issued.

3. This paper:

   a. outlines the general ways that the Board can approach contingencies;

   b. outlines the alternatives for accounting for contingencies in a business combination;

   c. summarises the staff recommendation—retain the IFRS 3 guidance for contingencies with some improvements (eliminating the term *contingent liability*, removing the probability recognition criterion and clarifying that 'possible assets' should not be recognised even if the realisation of income is virtually certain)—and questions for the Board; and

   d. analyses the alternatives by considering (1) the differences between the alternatives, (2) comments received and (3) the status of IAS 37 redeliberations for each of the following issues:

      i. terminology/recognition of 'possible obligations',

      ii. probability recognition criterion,

      iii. measurement attribute,

      iv. reliable measurement criterion,

v. subsequent accounting, and

vi. contingent assets.

OVERALL APPROACHES

4. The staff believe that there are two approaches available to the Board for addressing contingencies:

   a. **Approach 1**: Continue to address the accounting for contingencies comprehensively only in the IAS 37 project and align the issuance and effective dates of the business combinations standard and the revised IAS 37.

   b. **Approach 2**: Do not wait for the IAS 37 project to be completed before finalising the business combinations standard. Retain the IFRS 3 guidance for accounting for contingencies acquired/assumed in a business combination, possibly with some improvements based on the thinking in the IAS 37 project. Any guidance for contingencies provided in the business combinations standard will be reviewed when the Board is considering consequential amendments in the IAS 37 project.

5. The staff do not support Approach 1 because the timing and outcome of the IAS 37 project is uncertain. We do not support delaying the issuance or effective date of the business combinations standard to wait for the completion of the IAS 37 project.

6. Therefore the staff believe that the Board should finalise the business combinations standard, including guidance for accounting for contingencies acquired/assumed in a business combination, before the IAS 37 project is completed. This is consistent with the Board's February 2006 decision to reposition the IAS 37 project as a stand-alone project, rather than as accompanying the Business Combinations project. In doing so, the staff believe that the Board should try to benefit as much as possible from the thinking in the

IAS 37 project without prejudging the outcome of that project. That belief is reflected in the alternatives for accounting for contingencies in a business combination outlined in the next section.

7. ***Question 1: Does the Board agree that the business combinations standard, including guidance for accounting for contingencies acquired/assumed in a business combination, should be finalised before the IAS 37 project is completed (Approach 2)? Or does the Board want to continue to address contingencies comprehensively only in the IAS 37 project (Approach 1)?***

8. If the Board selects Approach 1, the remainder of this paper will not be discussed at the January meeting. All issues related to contingencies will be addressed only in the IAS 37 project and the issuance and effective dates of the business combinations standard and the revised IAS 37 will be aligned.

ALTERNATIVES FOR ACCOUNTING FOR CONTINGENCIES IN A BUSINESS COMBINATION

9. The staff believe that the Board has the following alternatives for accounting for contingencies acquired/assumed in a business combination. Any decision made by the Board will be reviewed when the Board is considering consequential amendments in the IAS 37 project.

   a. **IAS 37**—require contingencies acquired/assumed in a business combination to be accounted for in accordance with existing IAS 37. Any revisions to IAS 37 would automatically flow into the business combinations standard.

   b. **IFRS 3**—retain the IFRS 3 guidance for contingencies and allow the IAS 37 project to amend the business combinations standard.

   c. **IFRS 3 modified**—make some improvements to the IFRS 3 guidance for contingencies based on the tentative decisions in the IAS 37 project. Additional improvements, if necessary, could be made as part of the IAS 37 project.

d. **BC ED**—affirm the accounting for contingencies proposed in the BC ED.

10. The differences between these alternatives are analysed beginning in paragraph 23. Before doing that, this section outlines some overall considerations that might affect which alternative the Board selects.

Existence of the IAS 37 Project

11. Although the staff believe that the Board should address contingencies as part of the business combinations project, we note that the nature of the guidance provided by the Board might be influenced by the fact that the IAS 37 project is on the agenda. The Board might not want to make many (or any) changes to the existing guidance for contingencies because the guidance might change again when the IAS 37 project is completed or might lead one to question whether the guidance requires re-exposure (if it differs from the BC ED proposals). Some might view making changes to the accounting for contingencies in the business combinations standard as prejudging the outcome of the IAS 37 redeliberations.

12. Therefore the staff have included as alternatives using the existing IAS 37 or IFRS 3 guidance for accounting for contingencies until the IAS 37 project is completed. The staff note that applying the existing IAS 37 guidance to contingencies acquired/assumed in a business combination also would be a change to current practice for business combinations because ‘contingent liabilities’ are recognised in IFRS 3, but not in IAS 37. Therefore selecting the IAS 37 alternative might result in changes to current practice both when the business combinations standard is effective and when the revised IAS 37 standard is effective. In addition, the staff view the IAS 37 alternative as a step backwards because it would prevent acquirers from recognising ‘contingent liabilities’ assumed in a business combination.

13. Alternatively, the Board might decide to incorporate some (or all) of the thinking in the IAS 37 project into the business combinations standard. For

example, the Board might decide to incorporate those IAS 37 ED proposals that have been affirmed by the Board in redeliberations. The Board might select this alternative because it is uncertain when a final standard will be issued in the IAS 37 project, and this would allow the Board to make some improvements to the accounting for contingencies in a business combination in the interim period.

Convergence

14. Another consideration is convergence with the FASB. The FASB does not have a comprehensive project on liabilities on its agenda. Therefore the Boards are addressing this topic separately. The FASB discussed the accounting for contingencies in a business combination at its 19 December 2006 meeting, but did not reach any conclusions *[footnote reference omitted]*. At that meeting, the FASB considered:

    a. requiring recognition of either all contractual or all legally enforceable contingencies because those contingencies have little or no element uncertainty.

       Guidance for what would constitute “legally enforceable” would be taken from FASB Statement No. 143, *Accounting for Asset Retirement Obligations.* The FASB leaned toward supporting the legally enforceable alternative, but asked the staff to further research the operationality of that approach and what contingencies might go unrecognised if the FASB decided to require recognition of contractual contingencies rather than legally enforceable contingencies.

    b. subjecting all remaining contingencies to a recognition threshold.

       That threshold could be either **probable** (used with the same meaning as in FASB Statement No. 5, *Accounting for Contingencies*) or **more likely than not** (used with the same meaning as in FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes.*) The FASB leaned toward the more likely than not recognition threshold.

15. The FASB also considered whether all recognised contingencies should be measured at fair value and whether to allow an exception from recognition if a contingency could not be **reasonably estimated.** Some FASB members expressed a preference for measuring contingencies at fair value. Some

expressed a preference for measuring only those contingencies with little element uncertainty at fair value and all other contingencies using a best estimate in accordance with Statement 5. The FASB also asked the staff to consider an approach that would require all contingencies to be recognised except those that cannot be reasonably estimated (and would eliminate the contractual/legally enforceable recognition criterion).

16. The FASB will discuss the alternative approaches to the recognition and measurement of contingencies at a future meeting.

17. The staff acknowledge that the alternatives considered by the FASB might result in divergence in the Boards' respective business combinations standards. Although complete convergence is the goal, the staff believe that issuing a final standard with a converged *framework* for applying the acquisition method might be an acceptable approach. That is, if the Boards establish a common framework for applying the acquisition method, they can address/resolve any remaining differences in other current or future Board projects. Therefore, the Boards might decide to require different accounting treatments for contingencies acquired/assumed in a business combination in their respective business combinations standards and permit the Boards to address differences in the accounting for contingencies on a broader basis in stand-alone projects. The staff note that the Boards are already taking this approach (ie establishing a convergent framework and resolving differences in separate projects) with the definition of control and are considering this approach for the definition of fair value.

SUMMARY OF STAFF RECOMMENDATION AND QUESTIONS FOR THE BOARD

18. In summary, the staff recommend that the Board select the IFRS 3 modified alternative. That is, the staff recommend that the Board retain the IFRS 3 guidance for the accounting for contingencies acquired/assumed in a business combination with the following improvements:

a. eliminate the term *contingent liability* from the business combinations standard. This would clarify that only those items that meet the definition of a liability should be recognised (ie ‘possible obligations’ should not be recognised).

b. remove the probability recognition criterion from the business combinations standard.

c. clarify that ‘possible assets’ should not be recognised even if the realisation of income is virtually certain.

19. This proposal would result in:

a. contingencies acquired/assumed in a business combination being measured at fair value;

b. a contingency acquired/assumed in a business combination being recognised only when it satisfies the definition of an asset or liability and its fair value can be measured reliably; and

c. subsequent to initial recognition, contingencies being measured at the higher of (a) the amount that would be recognised in accordance with IAS 37 or (b) the amount initially recognised less any amortisation recognised under IAS 18.

20. The staff believe that this recommendation allows the Board to make some improvements to the existing guidance for contingencies, without prejudging the outcome of the IAS 37 project. The Board can consider additional improvements to the guidance for contingencies in the business combinations standard when it discusses consequential amendments in the IAS 37 project.

21. The next section provides the staff’s analysis of which improvements proposed in the BC ED should be made now in the business combinations standard and which should be considered by the Board in the future when it discusses consequential amendments in the IAS 37 project.

22. In summary, the staff seek the Board's input on the following issues:

- Question 2: Does the Board affirm the proposal to eliminate the term 'contingent liability' from the business combinations standard? (paragraph 34)

- Question 3: Does the Board affirm the proposal to remove the probability recognition criterion for liabilities from the business combinations standard? (paragraph 41)

- Question 4: Does the Board affirm the proposal to measure contingencies acquired or assumed in a business combination at fair value? (paragraph 53)

- Question 5: Does the Board agree that the reliable measurement criterion for contingencies should be retained in the business combinations standard, with guidance clarifying that, except in extremely rare circumstances, an entity will be able to measure reliably contingencies assumed in a business combination? (paragraph 65)

- Question 6: Does the Board agree that the IFRS 3 guidance on the subsequent accounting for contingent liabilities should be retained? That is, does the Board agree that after initial recognition, contingent liabilities should be measured at the higher of (a) the amount that would be recognised in accordance with IAS 37 or (b) the amount initially recognised less any amortisation recognised under IAS 18? (paragraph 76)

- Question 7: Does the Board agree that the business combinations standard should clarify that 'possible assets' should not be recognised even if the realisation of income is virtually certain and that no other changes to the accounting for 'contingent assets' should be made as part of the business combinations project? (paragraph 89)

STAFF ANALYSIS OF THE ALTERNATIVES

23. This section analyses which improvements proposed in the BC ED should be made now in the business combinations standard and which should be considered by the Board in the future when it discusses consequential amendments in the IAS 37 project. The analysis is based on the differences between the four alternatives (IAS 37, IFRS 3, IFRS modified and BC ED) outlined in the following table:

Issue	***IAS 37***	***IFRS 3***	***IFRS 3 Modified (Staff Recommendation)***	***BC ED***	***IAS 37 ED/ Redeliberations***
Terminology	Provisions and contingent liabilities	Liabilities and contingent liabilities	Contingencies	Contingencies	Non-financial liabilities. (In redeliberations, the Board decided to use the term *liability* both as the title and in the text of the Standard.)
'Possible obligations'	Not recognised (do not satisfy the definition of a liability)	Recognised if *reliably measurable* (part of definition of contingent liabilities, which are recognised)	Not recognised	Not recognised—eliminated in revised description of contingencies.	Not recognised—only items that satisfy the definition of a liability are recognised. (Affirmed in redeliberations.)
Probability recognition threshold?	Yes (IAS 37.14(b))	Yes—liabilities (IFRS 3.37(b)) No—contingent liabilities (IFRS 3.37(c))	No	No (BC ED.35)	No (Affirmed in redeliberations, subject to outcome of redeliberations on measurement.)
Measurement attribute	Best estimate of the expenditure required to settle the present obligation at the balance sheet date. (IAS 37.36)	Fair value (as described in IFRS 3.B16).	Fair value (IFRS 3 definition).	Fair value (FASB's FVM ED definition).	Amount that the entity would rationally pay to settle the present obligation or to transfer it to a third party on the balance sheet date. (IAS 37 ED.29) (Discussed, but not decided, in redeliberations.)

Issue	***IAS 37***	***IFRS 3***	***IFRS 3 Modified (Staff Recommendation)***	***BC ED***	***IAS 37 ED/ Redeliberations***
Reliable measurement recognition threshold?	Yes (IAS 37.14 (c))	Yes (IFRS 3.37(b) and (c))	Yes	No (BC ED.35)	Yes (IAS 37 ED.11(b)), but provides guidance that limits non-recognition. (IAS 37 ED.27) (Not yet discussed in redeliberations.)
Subsequent accounting	Measured at the current best estimate. Reversed if it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation. (IAS 37.59)	Measured at the higher of (a) the amount that would be recognised in IAS 37 or (b) the amount initially recognised less any amortisation recognised under IAS 18. (IFRS 3.48)	Retain IFRS 3 guidance—measure at the higher of (a) the amount that would be recognised in IAS 37 or (b) the amount initially recognised less any amortisation recognised under IAS 18.	Measured in accordance with IAS 37 revised or other IFRSs as appropriate. (BC ED.36)	Measured at the current amount that the entity would rationally pay to settle the present obligation or to transfer it to a third party on the balance sheet date. (IAS 37 ED.43) (Not yet discussed in redeliberations.)
Contingent assets	Not recognised until the realisation of income is virtually certain. (IAS 37.31-33)	Not recognised until the realisation of income is virtually certain.	Not recognised because ‘possible assets’ do not satisfy the definition of an asset.	Not recognised because ‘possible assets’ do not satisfy the definition of an asset.	Not recognised because ‘possible assets’ do not satisfy the definition of an asset. Items that do satisfy the definition of an asset are within the scope of IAS 38, except for reimbursement rights, which remain in the scope of IAS 37. (Not yet discussed in redeliberations.)

24. For each issue, the staff:

    a. explain the differences between the alternatives,

    b. summarise the comments received,

    c. outline the status of IAS 37 redeliberations (through October 2006, not including round-table discussions), and

    d. analyse the issue and recommend a course of action.

25. For those issues that the Board has discussed in IAS 37 redeliberations (terminology/recognition of ‘possible obligations’, probability recognition criterion, measurement attribute and element uncertainty), the summary of comments received and status of IAS 37 redeliberations is in Appendix A. That summary is based on the background materials for the IAS 37 round-table discussions. That allows Board members to refer to that summary, as needed, as an aid memoir, on the presumption that Board members are already familiar with those discussions. In addition, Board members can refer to January 2007 IASB Agenda Papers 4A and 4B for information on the roundtable discussions.

26. In summary, respondents’ views on the accounting for contingencies tended to vary by the type of respondent. The majority of preparers disagreed with recognising contingencies at fair value, based on concerns about relevance, reliable measurement, mixed accounting model, and element uncertainty. In contrast, the majority of auditors and users agreed with the initial recognition of contingencies at fair value. Similar to the preparers, the auditors expressed concerns about reliability of measurement, mixed accounting model, and element uncertainty, but they think those issues were not insurmountable. Users expressed concern about reliability and the mixed accounting model. However, the users believed that their concerns would be alleviated through disclosure.

Terminology/Recognition of 'Possible Obligations'

27. IAS 37 (paragraph 13) distinguishes between:

    a. **provisions –** which are recognised as liabilities (assuming that a reliable estimate can be made) because they are present obligations and it is probable that an outflow of resources embodying economic benefits will be required to settle the obligations; and

    b. **contingent liabilities –** which are not recognised as liabilities because they are either:

        i. *possible obligations*, as it has yet to be confirmed whether the entity has a present obligation that could lead to an outflow of resources embodying economic benefits; or

        ii. *present obligations* that do not meet the recognition criteria in IAS 37 (because either it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation, or a sufficiently reliable estimate of the amount of the obligation cannot be made).

    Therefore 'possible obligations' are not recognised under IAS 37.

28. IFRS 3 (paragraph 37) distinguishes between liabilities and contingent liabilities, both of which are required to be recognised if their fair values can be measured reliably. *[Sentences omitted from observer note]*. IFRS 3 uses the same definition of *contingent liability* as IAS 37. Therefore the guidance in IFRS 3 might result in the recognition of some 'possible obligations' that do not satisfy the definition of a liability.

29. The BC ED (paragraph 35) describes contingencies as **assets or liabilities** in which the amount of the future economic benefits embodied in the asset or required to settle the liability are contingent (or conditional) on the occurrence or non-occurrence of one or more uncertain future events. The BC ED and IAS 37 ED proposed eliminating the term 'contingent liability' because:

(a) according to the *Framework*, only *present* obligations are liabilities. Therefore it is misleading to describe *possible* obligations as liabilities, (even with the modifier ‘contingent’).

(b) describing unrecognised present obligations as contingent is contradictory. By definition, *present* obligations cannot be contingent on future events.

(c) using the same term to describe two different notions is confusing.

Staff Analysis and Recommendation

30. The staff recommend that the Board affirm the proposal to eliminate the term *contingent liability* from the business combinations standard. This proposal has already been affirmed by the Board in the IAS 37 redeliberations (see paragraphs A2-A5 of Appendix A).

31. The staff believe that this would be an improvement to IFRS 3 because it would distinguish between:

a. ‘possible obligations’, which should not be recognised because they do not satisfy the definition of a liability; and

b. those present obligations which would not be recognised under IAS 37 because they do not meet the probability recognition criterion in that Standard, but should be recognised when assumed in a business combination.

This would clarify that only those items that satisfy the definition of a liability should be recognised.

32. The remainder of the analysis in this paper relates only to those items that satisfy the definition of a liability (ie those items that are characterised as provisions and unrecognised present obligations in IAS 37). The analysis is not intended to apply

to those items characterised as 'possible obligations' in IAS 37 because those items do not satisfy the definition of a liability.

33. The staff recommend that the description of contingencies in the BC ED—assets or liabilities in which the amount of the future economic benefits embodied in the asset or required to settle the liability are contingent (or conditional) on the occurrence or non-occurrence of one or more uncertain future events—be retained in the business combinations standard.

34. ***Question 2: Does the Board affirm the proposal to eliminate the term* contingent liability *from the business combinations standard?***

Probability Recognition Criterion

35. IAS 37 states that an entity should recognise a provision only when it is *probable* (more likely than not) that an outflow of resources embodying economic benefits will be required to settle the obligation.[1]

36. IFRS 3 also includes this probability recognition criterion for liabilities, but not for contingent liabilities. *[Sentences omitted from observer note]*. The Board's basis for removing the probability recognition criterion for contingent liabilities in IFRS 3 is as follows:

> BC111 In developing ED 3 and the IFRS, the Board observed that although a contingent liability of the acquiree is not recognised by the acquiree before the business combination, that contingent liability has a fair value, the amount of which reflects market expectations about any uncertainty surrounding the possibility that an outflow of resources embodying economic benefits will be required to settle the possible or present obligation. As a result, the existence of contingent liabilities of the acquiree has the effect of depressing the price that an acquirer is prepared to pay for the acquiree, ie the acquirer has, in effect, been paid to assume an obligation in the form of a reduced purchase price for the acquiree.

[1] IAS 37, paragraphs 14(b) and 23.

BC112 The Board observed that this highlights an inconsistency between the recognition criteria applying to liabilities and contingent liabilities in IAS 37 and the *Framework* (both of which permit liability recognition only when it is probable that an outflow of resources embodying economic benefits will be required to settle a present obligation) and the fair value measurement of the cost of a business combination. Indeed, the probability recognition criterion applying to liabilities in IAS 37 and the *Framework* is fundamentally inconsistent with any fair value or expected value basis of measurement because expectations about the probability that an outflow of resources embodying economic benefits will be required to settle a possible or present obligation will be reflected in the measurement of that possible or present obligation. However, the Board agreed that the role of probability in the *Framework* should be considered more generally as part of a forthcoming Concepts project.

BC113 The Board also observed that the principles in IAS 37 had been developed largely for provisions that are generated internally, not obligations that the entity has been paid to assume. This is not dissimilar from situations in which assets are recognised as a result of the business combination, even though they would not be recognised had they been generated internally. For example, some internally generated intangible assets are not permitted to be recognised by an entity, but would be recognised by an acquirer as part of allocating the cost of acquiring that entity.

37. The BC ED and IAS 37 ED propose omitting the probability recognition criterion.

Staff Analysis and Recommendation

38. For the same reasons considered by the Board in the IAS 37 redeliberations (see paragraphs A6-A7 of Appendix A), the staff recommend that the Board affirm the BC ED proposal to remove the probability recognition criterion from the business combinations standard. Because this is consistent with the BC ED proposal, the staff believe that it is unlikely to require re-exposure.

39. *[Paragraph omitted from observer note]*

40. IFRS 3 has a probability recognition criterion for all assets acquired and liabilities assumed in a business combination except for intangible assets and contingent liabilities. The staff note that the removal of the probability recognition criterion

for contingencies would be consistent with the Board's decision to remove the probability recognition criterion for other assets acquired and liabilities assumed in a business combination.

41. ***Question 3: Does the Board affirm the proposal to remove the probability recognition criterion for liabilities from the business combinations standard?***

Measurement Attribute

42. 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.[2] The proposed measurement principle underpinning the IAS 37 ED is: An entity shall measure a 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. The proposed measurement principle is derived from the explanation of 'best estimate of the expenditure required to settle' in paragraph 37 of IAS 37. The Board therefore regarded the proposed principle as clarifying (rather than changing) the existing measurement principle. The Board noted that the existing principle in IAS 37 is ambiguous, but interpreted it to be based on a current settlement notion - the amount an entity would pay to settle the liability *on the balance sheet date* (either by settling its obligation with the counterparty or by transferring the obligation to a third party).

43. The IAS 37 ED explained that the Board decided to amend the IAS 37 measurement principle because the notion of 'best estimate of the expenditure required to settle' is unclear and may be interpreted in different ways. But the Board decided not to identify and evaluate all possible measurement principles for IAS 37 as part of the IAS 37 project in view of the comprehensive review of measurement being performed as part of its conceptual framework project.

[2] IAS 37, paragraph 36.

44. IFRS 3 requires that liabilities and contingent liabilities assumed in a business combination be measured at their acquisition-date fair values. Paragraph B16 of IFRS 3 provides additional guidance on the measurement of assets acquired and liabilities assumed in a business combination. It clarifies that *liabilities* should be measured at the present values of amounts to be disbursed in settling the liabilities determined at appropriate current interest rates (IFRS 3.B16(j)). *Contingent liabilities* should be measured at amounts that a third party would charge to assume those contingent liabilities. Such an amount shall reflect all expectations about possible cash flows and not the single most likely or the expected maximum or minimum cash flow (IFRS 3.B16(l)).

45. The BC ED proposes that contingencies be measured at fair value at the acquisition date. The BC ED defines fair value based on the FASB's FVM ED as 'the price at which an asset or liability could be exchange in a current transaction between knowledgeable, unrelated willing parties'. In October 2006 the IASB decided that the definition of fair value in IFRS 3 should be retained in the business combinations standard until the completion of the IASB's Fair Value Measurements project. As a result, fair value will be defined in the business combinations standard as 'the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction' in the business combinations standard.

Staff Analysis and Recommendation

46. The staff considered the following alternatives for measuring contingencies acquired/assumed in a business combination:

    a. Alternative One: measure contingencies acquired/assumed in a business combination at fair value.

b. Alternative Two: make a measurement exception for contingencies and require them to be measured in accordance with the IAS 37 measurement attribute.

47. The staff recommend that the Board affirm the BC ED proposal to measure contingencies acquired/assumed in a business combination at fair value (Alternative One). Based on the Board's October 2006 decision, contingencies would be measured at 'the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction'.

48. Measuring contingencies acquired/assumed in a business combination at fair value is consistent with the measurement principle agreed to by the Boards in the business combinations project. The Board agreed that fair value is the most relevant measurement attribute for accounting for the assets and liabilities in a business combination. If the Board was to select a different measurement attribute, the measurement of contingencies would be an exception to the fair value measurement principle.

49. The Board has decided that an exception to the business combinations measurement principle might be warranted for cost-benefit reasons or if fair value measurement at the acquisition date would result in a Day 1 gain or loss because of the subsequent accounting required by other IFRSs. The staff do not support Alternative Two (measuring contingencies in accordance with IAS 37) for the following reasons:

a. Contingencies are already required to be measured at fair value in IFRS 3. Therefore using the IAS 37 measurement attribute would be a change from the current IFRS 3 requirements for contingencies in a business combination.

b. The Board decided that the IAS 37 measurement attribute needs to be clarified because the notion of 'best estimate of the expenditure required to settle' is unclear and may be interpreted in different ways. However, the Board has not yet reached a tentative decision in the IAS 37 redeliberations on what measurement guidance will be provided in the revised IAS 37.

c. The Board acknowledged in the IAS 37 project that the IAS 37 measurement requirements and fair value are similar. However, the Board decided against labelling the proposed measurement principle 'fair value' as part of the IAS 37 project. In addition, the Board has decided not yet to explore further the differences between fair value and the IAS 37 measurement attribute. If the Board decided to make a measurement exception for contingencies in the business combinations standard (and require contingencies to be measured in accordance with IAS 37), it would have to explain how the IAS 37 measurement attribute is different than fair value.

d. The staff is proposing that the Board retain the IFRS 3 subsequent accounting for contingencies (see analysis beginning in paragraph 66). Under IFRS 3, after initial recognition, contingent liabilities are measured at the higher of (a) the amount that would be recognised in accordance with IAS 37 or (b) the amount initially recognised less any amortisation recognised under IAS 18 *Revenue*. Therefore the potential for Day 1 gains is mitigated.

50. The measurement attribute selected for contingencies in the business combinations standard will be reviewed when the IAS 37 project is completed. At that time, the Board will consider whether revisions to the IAS 37 measurement attribute, if any, are so significant that a measurement exception for contingencies might be warranted in the business combinations standard. However, the Board might

decide that it is appropriate to retain fair value as the measurement attribute for contingencies in a business combination because those contingencies are acquired/assumed as part of a transaction, whereas IAS 37 addresses liabilities that arise on a day-to-day basis.

51. Some constituents questioned whether measuring contingencies at a current settlement notion estimated by applying an expected cash flow approach provides relevant information because that measurement does not reflect the individual most likely outcome of the amount that will be paid or received. The Board considered those comments in the IAS 37 redeliberations and affirmed its preference for a measurement based on a current settlement notion estimated by applying an expected cash flow approach (see paragraphs A15-A16 of Appendix A).

52. Several respondents requested additional guidance on the fair value measurement of contingencies. The staff plan to address these comments as part of our overall analysis on what additional guidance should supplement the IFRS 3 definition of fair value in the business combinations standard. We plan to bring that analysis to a future meeting.

53. ***Question 4: Does the Board affirm the proposal to measure contingencies acquired or assumed in a business combination at fair value?***

Reliable Measurement Criterion

54. IAS 37 states that an entity should recognise a liability only when a reliable estimate can be made of the amount of the obligation. IAS 37 (paragraph 25) also states that, except in extremely rare cases, an entity will be able to determine a range of possible outcomes and can therefore make an estimate of the obligation that is sufficiently reliable to use in recognising a provision.

55. IFRS 3 also states that an acquirer should recognise a liability or contingent liability only when its fair value can be measured reliably.

56. The IAS 37 ED (paragraph 27) proposes to retain the reliable measurement criterion, but states '[e]xcept in extremely rare cases, an entity will be able to determine a reliable measure of a liability'.

57. The BC ED proposes to omit the reliable measurement criterion. The Board's basis is as follows:

> BC98 IFRS 3 states that any asset acquired or liability assumed in a business combination must be able to be measured reliably to be recognised. The Board decided not to include an equivalent statement in the draft revised IFRS 3 because it is a criterion for recognition in the *Framework*.

Comments Received

58. Many objected to the proposal to remove the reliable measurement criterion for contingencies from IFRS 3 because the IASB *Framework* specifically includes a reliable measurement criterion. For example, paragraph 91 of the *Framework* states that a liability is recognised only when 'the amount at which the settlement will take place can be measured reliably.'[3]

59. In addition, many respondents expressed concern about the ability to reliably measure contingencies, especially single, unique obligations. Those respondents noted that the absence of a market or information based on past experience increases reliance on subjective estimates.

IAS 37 Redeliberations

60. The Board has not redeliberated the proposal to retain the reliable measurement criterion in IAS 37. However, in discussions about using expected value to measure liabilities in the scope of IAS 37, the Board emphasised that:

- many equate reliability with the proximity of the measure of a liability on the balance sheet date to the actual cash flow required to settle the

[3] See also *Framework* paragraph 83(b).

liability. But a difference between the measure of a liability on the balance sheet date and the actual cash flow required to settle a liability does not necessarily mean that the measure was ‘wrong’.

- ‘reliable measurement’ refers to the reliability of the inputs used to estimate a liability and application of the chosen estimation technique.
- the subjectivity required to measure a liability based on a current settlement notion (estimated by applying an expected cash flow approach) is no greater than the subjectivity required to estimate the individual most likely cash flow required to settle a liability. An estimate of the individual most likely cash flow required to settle a liability (ie the cheque the entity expects to write) requires speculation about future events for which no objective evidence exists on the balance sheet date (for example, technological advances or changes in the law). An estimate based on a current settlement notion is also subjective, but is based on objective evidence that exists on the balance sheet date.

Staff Analysis and Recommendation

61. The staff recommend that the Board retain the reliable measurement criterion for contingencies in the business combinations standard, but include guidance to clarify the instances in which non-recognition would occur. For example, include guidance similar to that in paragraph 25 of IAS 37:

> Except in extremely rare cases, an entity will be able to determine a range of possible outcomes and can therefore make an estimate of the obligation that is sufficiently reliable to use in recognising a provision.

62. The staff’s recommendation is based on the following factors:

    a. The comment letters indicate that some constituents believe that the proposal to remove the reliable measurement criterion from IFRS 3 conflicts with the *Framework*, even though the BC ED's Basis for Conclusions explains that the reliable measurement criterion in the *Framework* should apply. Therefore the staff believe that the business combinations standard should explicitly state that contingencies must be able to be measured reliably in order to be recognised, instead of implicitly requiring reliable measurement through the *Framework.*

b. The IAS 37 ED proposes to retain the reliable measurement criterion. The BC ED does not explain whether or why the Board believes that all contingent liabilities can be measured reliably in a business combination, but not outside of a business combination. The staff acknowledge that the transaction price for the business provides a basis for measuring the assets acquired and liabilities assumed. However, the staff is not convinced that permits the reliable measurement of **all** contingencies.

c. Many respondents expressed concern about the ability to reliably measure contingencies.

63. Some Board and staff members have suggested an alternative approach to addressing the issue of reliable measurement for contingencies. That approach would involve developing recognition criteria for liabilities similar to those used to establish a reliable measurement threshold for intangible assets (ie contractual-legal or separable). The staff have not been able to develop recognition criteria that we believe would be operational. For example, we believe that a contractual-legal threshold would not be operational because some contractual-legal liabilities might not be able to be measured reliably (eg asset retirement obligations (AROs)). FASB Statement No. 143, *Asset Retirement Obligations,* includes an exception from recognition for those AROs that cannot be measured reliably. In addition, such a threshold might prevent the recognition of some contingent liabilities that can be measured reliably and would be required to be recognised under the current IFRS 3.

64. The staff believe that disclosures might mitigate the loss of information about contingencies that are not recognised because they cannot be reliably measured. For example, the IAS 37 ED proposed the following disclosure requirement:

> 69 If a non-financial liability is not recognised because it cannot be measured reliably, an entity shall disclose that fact together with:
>
> (a) a description of the nature of the obligation;
>
> (b) an explanation of why it cannot be measured reliably;
>
> (c) an indication of the uncertainties relating to the amount and timing of any outflow of economic benefits; and
>
> (d) the existence of any right to reimbursement.

65. ***Question 5: Does the Board agree that the reliable measurement criterion for contingencies should be retained in the business combinations standard, with guidance clarifying that, except in extremely rare circumstances, an entity will be able to measure reliably contingencies assumed in a business combination?***

Subsequent Accounting

66. IAS 37 (paragraph 59) requires that provisions be reviewed at each balance sheet date and adjusted to reflect the current best estimate. If it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation, the provision is reversed.

67. After initial recognition, IFRS 3 (paragraph 48) requires contingent liabilities to be measured at the higher of (a) the amount that would be recognised in accordance with IAS 37 or (b) the amount initially recognised less any amortisation recognised under IAS 18. The Board's basis for this guidance is as follows:

> BC114 In developing ED 3 the Board proposed that a contingent liability recognised as part of allocating the cost of a business combination should be excluded from the scope of IAS 37 and measured after initial recognition at fair value with changes in fair value recognised in profit

> or loss until settled or the uncertain future event described in the definition of a contingent liability is resolved. While considering respondents' comments on this issue, the Board noted that measuring such contingent liabilities after initial recognition at fair value would be inconsistent with the conclusions it reached on the accounting for financial guarantees and commitments to provide loans at below-market interest rates when revising IAS 39 *Financial Instruments: Recognition and Measurement*.
>
> BC115 The Board decided to amend the proposal in ED 3 for consistency with IAS 39. Therefore, the IFRS requires contingent liabilities recognised as part of allocating the cost of a combination to be measured after their initial recognition at the higher of:
>
> (a) the amount that would be recognised in accordance with IAS 37, and
>
> (b) the amount initially recognised less, when appropriate, cumulative amortisation recognised in accordance with IAS 18 *Revenue*.
>
> The Board observed that not specifying the subsequent accounting might result in some or all of these contingent liabilities inappropriately being derecognised immediately after the combination.

68. The BC ED proposes that, after initial recognition, the acquirer should account for contingent liabilities in accordance with IAS 37 revised or other IFRSs, as appropriate. The IAS 37 ED proposes that the carrying amount of a non-financial liability should be reviewed at each balance sheet date and adjusted to reflect the current amount that the entity would rationally pay to settle the present obligation or transfer it to a third party on that date.

Comments Received

69. The majority of preparers disagreed with the proposed subsequent accounting for contingencies, expressing concerns about the on-going costs of having to remeasure contingencies to fair value at each reporting period and inappropriate income statement volatility.

70. Several auditors agreed with the initial recognition of contingencies at fair value in a business combination, but expressed concerns about the subsequent accounting proposed in the BC ED. Some recommended that the Board retain the IFRS 3 requirements for the subsequent accounting of contingencies. For example, Deloitte (CL #22) stated:

> …we have the following concerns regarding the Exposure Drafts' accounting for contingent assets and contingent liabilities subsequent to the acquisition date:
>
> - The accounting method outlined in the Exposure Drafts for contingent assets acquired and contingent liabilities assumed in a business combination is inconsistent with subsequent accounting for contingencies absent a business combination. Under the Exposure Drafts, there would be two different models for accounting for contingencies subsequent to initial recognition: one model for an acquirer's contingencies and those of the acquiree that arise subsequent to an acquisition, and a second for an acquiree's contingencies that existed as of the acquisition date.
>
> - There are complexities involved with measuring such contingencies at fair value at each reporting period. For example, difficulties will arise when contingencies of an acquirer and acquiree become commingled (e.g., if an acquirer and acquiree are defendants in the same lawsuit).
>
> Therefore, we propose the following alternative approach…Subsequent to the acquisition date, contingent liabilities should be measured in accordance with paragraph 48 of IFRS 3 at the greater of (1) the fair value at the acquisition date (less cumulative amortization where appropriate) or (2) the contingent liability amount required to be recognized by FASB Statement No. 5, *Accounting for Contingencies,* or IAS 37, until extinguished.

71. PwC (CL #66) stated:

> We do not agree with the proposal to record changes in fair value in income in subsequent reporting periods for acquired contingencies that would otherwise be in the scope of SFAS 5 or IAS 37. IFRS and US GAAP currently require that many financial statement items are recorded on a historical-cost basis while others are reflected at fair value. The proposed changes would further exacerbate issues with this mixed-attribute model, by requiring that similar types of financial statement items be treated differently. We also believe it would be difficult for users to understand the operating results of an entity when income reflects the changes in the recorded amounts of similar, or perhaps the same assets and liabilities, on different bases of accounting. We believe the difficulty faced by

> many preparers trying to estimate the fair value of these assets and liabilities will further undermine the relevance of regular re-measurement. Finally, we do not believe that the income statement is properly constructed at present to delineate changes in earnings that are as a result of changes in fair value from those that result from other operating activities. These issues should be addressed through thorough debate and proper due-process regarding the overall reporting model including the reporting of financial performance.
>
> Accordingly, until such debate regarding re-measurement occurs, we believe it is necessary to bridge the accounting model for initial recognition with the historical cost model for contingencies that arise outside of a business combination. We suggest a model that is similar to that in IFRS 3 whereby the value of the contingency in subsequent periods is the greater of the fair value recognised initially or the amount that would result from applying SFAS 5 or IAS 37. When the contingency comes within the scope of SFAS 5 or IAS 37, it should be accounted for in accordance with those standards and any changes in the acquired contingency as a result of applying this guidance should be recorded in income in each reporting period.

IAS 37 Redeliberations

72. The Board does not plan to discuss the subsequent accounting of liabilities in the IAS 37 redeliberations because there is currently consistency in IAS 37 between initial and subsequent accounting for contingencies and the IAS 37 ED does not propose changing this. However, as part of the discussion of consequential amendments in the IAS 37 project, the Board will consider whether any amendments should be made to the guidance for contingencies in the business combinations standard. This will include a consideration of whether any changes to the subsequent accounting for contingencies assumed in a business combination are warranted.

Staff Analysis and Recommendation

73. Because the IAS 37 project will not be completed until after the business combinations project, the business combinations standard cannot refer to IAS 37 for guidance on subsequent accounting. If the Board decides to require some contingent liabilities to be recognised in the business combinations standard that

are not recognised under IAS 37, the Board will have to provide guidance on the subsequent accounting for those liabilities or they could be derecognised immediately after the business combination. Therefore the staff believe that the Board has the following alternatives for the subsequent accounting of contingencies assumed in a business combination:

a. Alternative One: Retain the IFRS 3 subsequent accounting guidance for contingencies assumed in a business combination until the IAS 37 project is completed.

b. Alternative Two: Require contingencies assumed in a business combination to be remeasured at fair value at each balance sheet date.

74. The staff recommend that the Board select Alternative One (retain the guidance for subsequent accounting in IFRS 3 until the IAS 37 project is completed). That is, the staff recommend that contingencies be measured at the higher of (a) the amount that would be recognised in accordance with IAS 37 or (b) the amount initially recognised less any amortisation recognised under IAS 18.

75. Alternative One was supported by many respondents. In addition, the staff believe that requiring all contingencies acquired in a business combination to be remeasured at fair value at each reporting date might require re-exposure because the BC ED proposed subsequent measurement in accordance with the revised IAS 37, not subsequent measurement at fair value. The staff believe that this issue should be reviewed when the Board is considering consequential amendments in the IAS 37 project.

76. ***Question 6: Does the Board agree that the IFRS 3 guidance on the subsequent accounting for contingent liabilities should be retained? That is, does the Board agree that after initial recognition, contingent liabilities should be measured at the higher of (a) the amount that would be recognised in accordance with IAS 37***

or (b) the amount initially recognised less any amortisation recognised under IAS 18?

Contingent Assets

77. IAS 37 defines a contingent asset as 'a **possible asset** that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain events not wholly within the control of the entity' (IAS 37.10, emphasis added).

78. IAS 37 (paragraphs 31, 34) prohibits the recognition of contingent assets, but requires that contingent assets be disclosed when an inflow of economic benefits is probable. In addition, paragraph 33 of IAS 37 states:

> Contingent assets are not recognised in financial statements since this may result in the recognition of income that may never be realised. However, **when the realisation of income is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate**. (emphasis added)

79. Under IFRS 3, contingent assets acquired in a business combination are not recognised until the realisation of income is virtually certain (ie when the related asset is no longer a contingent asset).

80. The BC ED and IAS 37 ED:

    a. propose eliminating the term 'contingent asset'.

    b. use the term 'contingency' to refer to uncertainty about the amount of the future economic benefits embodied in an asset, rather than uncertainty about whether an asset exists.

    c. specify that items previously described as contingent assets, but satisfying the definition of an asset in the *Framework*, are within the scope of IAS 38 *Intangible Assets* rather than IAS 37 (except for rights to reimbursements, which remain within the scope of IAS 37).

81. The purpose of the amendments is to clarify that only resources currently controlled by the entity as a result of a past transaction or event (rather than possible assets) give rise to assets. Therefore 'possible assets' should not be recognised even if the realisation of income is virtually certain.

Comments Received

82. Respondents' views on this are similar to their views on eliminating the term 'contingent liability'. That is to say, some respondents agree that there is no need for the term, but state that the Board needs to provide clearer guidance about what gives rise to an asset (unconditional right). Others think that the term appropriately captures circumstances in which it is uncertain whether an asset exists and therefore it should be retained.

83. Many respondents agree that IAS 37 is not the appropriate standard for assets, but do not agree that IAS 38 should be used as a 'catch all' standard for assets. The reasons articulated by respondents are:

- Not all items currently described as contingent assets meet the definition of an intangible asset in IAS 38. Some respondents believe that items previously described as contingent assets are inherently financial in nature and that such 'monetary' items are more appropriately placed within the scope of IAS 39.

- IAS 38 does not provide adequate guidance for recognition, initial measurement and subsequent measurement of items previously known as contingent assets. For example, IAS 38 guidance on amortisation, depreciable amounts, and residual value may result in items previously known as contingent assets being amortised. Respondents do not believe this is an appropriate outcome.

- The proposals create different criteria for the recognition of assets and liabilities formerly described as contingent. This is because the ED proposes omitting the probability recognition criterion and therefore reflects all uncertainty in the measurement of a liability. However, no similar changes are proposed to IAS 38. Conversely, a few respondents prefer to retain the 'virtual certainty' recognition threshold for items previously known as contingent assets.

- Similarly there are no changes proposed to the measurement requirements for assets now within the scope of IAS 38. Respondents are therefore concerned that the combination of unchanged recognition and measurement requirements may result in an imbalance between assets and liabilities with an overall understatement of shareholders' equity.

84. Some suggest either a new standard to address the accounting for items previously known as contingent assets or including additional guidance in IAS 38. Others suggest adding disclosure requirements to IAS 38 to capture items previously described as contingent assets and disclosed under IAS 37.

IAS 37 Redeliberations

85. The Board has not discussed contingent assets in the IAS 37 redeliberations.

Staff Analysis and Recommendation

86. The staff recommend that the IFRS 3 guidance for contingent assets be retained, with one slight improvement. Because the definition of contingent asset includes only 'possible assets', the staff believe that the IFRS 3 guidance that prohibits the recognition of contingent assets is appropriate. *[Remainder of paragraph omitted from observer note]*

87. However, the staff recommend that the business combinations standard clarify that only items that meet the definition of an asset should be recognised. Therefore 'possible assets' should not be recognised even if the realisation of income is virtually certain. The staff believe that the revised description of contingencies proposed in the BC ED will clarify this point.

88. The staff believe that additional improvements (eg eliminating the term *contingent asset*) and guidance on 'contingent assets' should be made in the IAS 37 project.

89. ***Question 7: Does the Board agree that the business combinations standard should clarify that 'possible assets' should not be recognised even if the realisation of income is virtually certain and that no other changes to the accounting for 'contingent assets' should be made as part of the business combinations project?***

FOR REFERENCE PURPOSES ONLY.

APPENDIX A: SUMMARY OF COMMENTS RECEIVED AND STATUS OF IAS 37 REDELIBERATIONS

A1. This appendix summarises the comments received and the status of IAS 37 redeliberations (through October 2006, not including round-table discussions) for those issues in the table in paragraph 23 that the Board has discussed in the IAS 37 redeliberations. This appendix is based on the background materials for the IAS 37 round-table discussions. Refer to January 2007 IASB Agenda Papers 4A and 4B for more information on the round-table discussions.

Terminology/Recognition of 'Possible Obligations'

Comments Received

A2. The IAS 37 ED comment letters indicate that many respondents share the Board's concerns about the term 'contingent liability'. But some disagree, arguing that the term is well understood and consistently applied in practice.

A3. Some respondents agreed with the proposal to eliminate the term 'contingent liability'. Nonetheless, many of them were concerned that the ED's proposals might reduce the amount of useful disclosure about possible obligations, ie items that do not satisfy the definition of a liability but that are currently subject to IAS 37 disclosure requirements for 'contingent liabilities'.

IAS 37 Redeliberations

A4. After considering the views expressed in the comment letters, the Board tentatively affirmed its proposal to eliminate the term 'contingent liability' from IAS 37. (For further analysis, see IAS 37 Agenda Paper 4A from the July 2006 meeting.)

A5. At a future meeting, the Board will consider disclosures to capture important information about items which do not satisfy the definition of a liability on the balance sheet date, but that are currently subject to IAS 37 disclosure requirements for 'contingent liabilities'.

Probability Recognition Criterion

Comments Received

A6. Many objected to the proposal to omit the probability recognition criterion from IAS 37 because the IASB *Framework* specifically includes a probability recognition criterion. For example, paragraph 91 of the *Framework* states that a liability is recognised only when 'it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation.'[4] Others objected to the proposal because they believe the criterion is a practical means of addressing uncertainty about the existence of a present obligation.

IAS 37 Redeliberations

A7. The Board acknowledges that its proposal to omit the probability recognition criterion creates tension with the *Framework*. It has therefore reconsidered but tentatively affirmed its proposal. (For further analysis, see IAS 37 Agenda Paper 3A from the June 2006 meeting.) In the Board's view, there is no need for a separate probability recognition criterion in IAS 37 because any uncertainty about the amount or timing of the economic benefits required to settle a present obligation should be reflected in measurement, not recognition. This is because:

(a) the *Framework* does not define 'probable'. Moreover, IAS 37 and IFRS 3 have established a unique interpretation of probability ('more likely than not').

[4] See also *Framework* paragraph 83(a).

(b) other standards do not apply a probability recognition threshold. For example, IAS 39 *Financial Instruments: Recognition and Measurement* does not permit a writer of an option to delay the recognition of its obligation to deliver a commodity at a fixed price in the future until it is ‘more likely than not’ that the holder will exercise the option. Similarly, IAS 19 *Employee Benefits* does not permit an employer to delay the recognition of its obligation to provide long-term compensated absence to employees completing *x* years service until it is ‘more likely than not’ that an employee will complete *x* years service.[5]

(c) a probability recognition criterion may result in inconsistent accounting for identical liabilities within the scope of IAS 37. For example, such a criterion would mean an entity would not recognise a liability arising from a single product warranty if it is 30 per cent likely that a fault is reported during the warranty period. But the same entity would recognise a liability if the entity had issued one hundred identical product warranties (even though it remains 30 per cent likely that a fault is reported for each individual product). This is because it is ‘more likely than not’ that at least one product will develop a fault during the warranty period.

(d) applying a probability recognition criterion creates tension with the measurement requirements in IAS 37 and might delay the reporting of useful information about items which satisfy the definition of a liability. For example, paragraphs 39 and 40 of IAS 37 require an entity to consider all possible outcomes in the measurement of a liability, regardless of whether each possible outcome is ‘more likely than not’.[6]

[5] In some jurisdictions this type of long-term compensated absence is known as ‘long service leave’.

[6] IAS 37, paragraph 39 states that when the liability being measured involves a large population of items, the liability is measured ‘by weighting *all possible outcomes* by their associated probabilities.’ Paragraph 40 states that the individual most likely outcome may be the best estimate of a single liability but ‘even in such a case, *the entity considers other possible outcomes*.’ (emphasis added)

(e) a probability recognition criterion might detract from the first step in accounting for liabilities: does a liability exist on the balance sheet date?

Measurement Attribute

Comments Received

A8. The IAS 37 comment letters indicate that many respondents do not share the Board's understanding of the existing IAS 37 measurement principle. Those respondents understand the existing measurement principle to be an ultimate settlement notion – ie to depict the cash outflow that an entity expects to incur to settle a present obligation *in the future*.

A9. Therefore many respondents perceive the impact of the proposed amendments to the measurement principle to be greater than the Board intended. In particular, several argued that the IAS 37 ED implicitly proposes to establish fair value as the measurement principle for liabilities within the scope of IAS 37 – an outcome most would not support.

A10. Moreover, the comment letters indicate that some respondents believe that the proposed measurement principle permits choice. They believe there is a difference between the 'amount to settle' and the 'amount to transfer' a present obligation on the balance sheet date.

A11. The IAS 37 comment letters also indicate that many are not confident that a measurement principle based on a current settlement notion (estimated by applying an expected cash flow approach to all liabilities within the scope of IAS 37) will provide useful information. Common concerns expressed in the comment letters are:

(a) markets do not exist for many liabilities within the scope of IAS 37. Measuring a liability based on a hypothetical transaction fails to reflect economic reality, and therefore is irrelevant for users of financial statements.

(b) the absence of a market increases reliance on subjective estimates. Estimates decrease the reliability, comparability and verifiability of financial statements and increase the risk of inappropriate earnings management.

(c) measurement based on a current settlement notion is likely to increase volatility in profit or loss. It would therefore be more difficult for users to understand an entity's financial performance and compare its financial performance from one period to the next.

(d) a wide range of possible outcomes may exist for single obligations and present obligations with a low probability of an outflow of economic resources. An estimate based on a current settlement notion is unlikely to equal any of the future possible outcomes, and therefore does not provide useful information to users.

(e) complex models may be needed to measure liabilities within the scope of IAS 37. The cost of developing these models might outweigh the benefit of additional information provided.

A12. Several respondents argued that a measurement principle based on an estimate of the cash outflow required to settle a liability (estimated using the individual most likely outcome) would provide more useful information about liabilities within the scope of IAS 37.

IAS 37 Redeliberations

A13. The Board has tentatively affirmed its decision to make limited amendments to the IAS 37 measurement principle. The Board noted that the comment letters supported its view (explained in the ED) that 'best estimate of the expenditure required to settle' is not a clear measurement principle and has caused divergence in practice. Whilst acknowledging similarities between the IAS 37 measurement requirements and fair value, the Board also decided against labelling the proposed measurement principle 'fair value' as part of this project.

A14. In the light of the comments received, the Board has re-examined the IAS 37 measurement principle. The Board acknowledges that the wording of the principle and accompanying guidance is not always clear. Nonetheless, the Board has tentatively affirmed its belief that the existing measurement principle is based on a current settlement notion. (For further analysis, see IAS 37 Agenda Paper 8B from the September 2006 meeting.)

A15. The Board has evaluated the relative merits of both a measurement principle based on a current settlement notion and a measurement principle based on an estimate of the cash flow required to settle a liability (the individual most likely outcome) using the attributes of useful information described in the *Framework* (qualitative characteristics). Appendix B summarises the outcome of this evaluation. (For further analysis, see IAS 37 Agenda Paper 8C from the September 2006 meeting.)

A16. Both measurement principles provide useful information about liabilities within the scope of IAS 37. But on the basis of this evaluation, the Board has tentatively affirmed its preference for a measurement based on a current settlement notion (estimated by applying an expected cash flow approach to measure all liabilities within the scope of IAS 37, including single obligations). In reaching this conclusion, the Board particularly emphasised that a current settlement notion (estimated by applying an expected cash flow approach) incorporates in the estimate of a liability all information about a liability that is available on the balance sheet date. In contrast, a measurement principle based on an estimate of the cash outflow required to settle a liability (the individual most likely outcome) ignores some information about a liability that is available on the balance sheet date.

A17. The Board has also reconsidered the wording of the measurement principle proposed in the IAS 37 ED. The Board acknowledges that using two phrases ('amount to settle' and 'amount to transfer') to express the principle is confusing. The Board has therefore tentatively decided to remove one of the phrases from the measurement principle in any new Standard.

A18. The Board has noted that 'amount to settle' is broader than 'amount to transfer' and may be interpreted in different ways. Moreover, the counterparty might demand more than the rational economic value of a liability to 'settle' the liability on the balance sheet date. However, the Board was concerned that retaining only 'amount to transfer' might imply that it was specifying fair value as the IAS 37 measurement objective – a decision that is beyond the scope of this project.

A19. The Board has not yet concluded its redeliberations on this issue. It intends to develop an example illustrating how an entity should measure a liability using the following draft guidelines:

- The proposed measurement principle 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 one of two ways: 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. In the absence of market information, entity-specific information is consistent with the measurement principle provided there is no indication that it is inconsistent with the information the market would use.

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APPENDIX B: EVALUATION OF MEASUREMENT PRINCIPLES FOR LIABILITIES WITHIN THE SCOPE OF IAS 37

B1. This appendix uses a lawsuit as an example of a liability to evaluate the relative merits of a measurement principle based on a current settlement notion (estimated using an expected cash flow approach) and a measurement principle based on an estimate of the cash outflow required to settle a liability (using the individual most likely outcome).

B2. The fact pattern in this example is acknowledged to be simplistic compared with the fact pattern in a 'real' lawsuit. This example ignores the time value of money and any risk inherent in the liability itself. However, the Board considered that a more complex fact pattern might detract from an evaluation of the two measurement principles.

FACT PATTERN

B3. Entity X is being sued (is the subject of a lawsuit). Entity X agrees that its past actions violated a law and that the law requires Entity X to pay compensation to the plaintiff for damages caused by Entity X's past actions. In other words, it is certain that the definition of a liability is satisfied. However, Entity X disputes the amount of compensation demanded by the plaintiff for damages caused by Entity X's past actions.

B4. On the basis of legal advice, as at 31 December 20X0 Entity X estimates that it is 5 per cent likely that the court will order Entity X to pay CU100 million to the plaintiff (the amount demanded by the plaintiff), 90 per cent likely that the court will order Entity X to pay CU40 million to the plaintiff; and 5 per cent likely that the court will order Entity X to pay CU20 million to the plaintiff.[7] There are no other possible cash outflows.

B5. During the half-year ended 30 June 20X1 new information about the lawsuit becomes available which is favourable to Entity X. On the basis of legal advice, Entity X now estimates that it is 55 per cent likely that the court will order Entity X to pay CU40 million to the plaintiff; and 45 per cent likely that the court will order Entity X to pay CU20 million to the plaintiff.

EVALUATION

Estimate	**Current settlement notion (estimated by applying an expected cash flow approach)[8]**	**Cash outflow required to settle a liability (using the individual most likely outcome)**
31 December 20X0	CU42 million	CU40 million
30 June 20X1	CU31 million	CU40 million

Qualitative characteristic	**Current settlement notion (estimated using an expected cash flow approach)**	**Cash outflow required to settle a liability (using the individual most likely outcome)**
Relevance (*Framework*, 26-28)	Reflects information about all possible outflows and the change in management's estimate due to new information about the liability becoming available during the period ended 30 June 20X1. This information could be capable of making a difference to users in their decision making. Does not reflect management's estimate of the individual most likely cash outflow required to settle the lawsuit.	Reflects management's estimate of the most likely cash outflow required to settle the lawsuit. Does not reflect information about other possible cash outflows or the change in management's estimate due to new information about the liability becoming available during the period ended 30 June 20X1.

[7] CU = currency units

[8] 5% of CU100m + 90% of CU40m + 5% of CU20m = CU42m
55% of CU40m + 45% of CU20m = CU31m

Qualitative characteristic	**Current settlement notion (estimated using an expected cash flow approach)**	**Cash outflow required to settle a liability (using the individual most likely outcome)**
Faithful representation - necessary to achieve reliability (*Framework*, 33-34)	The decrease in Entity X's liability on 30 June 20X1 reflects the effect of known events that occurred during the period.	Entity X's liability remains unchanged on 30 June 20X1. It does not reflect the effect on management's estimate of known events that occurred during the period.
Substance over form – necessary to achieve reliability (*Framework*, 35)	Not applicable to this example.	Not applicable to this example.
Neutrality - necessary to achieve reliability	Uses independent legal advice to apply an expected cash flow approach. Management's estimate can be verified by reference to this legal advice.	Uses independent legal advice to estimate the most likely cash outflow required to settle the obligation. Management's estimate can be verified by reference to this legal advice.
Prudence – necessary to achieve reliability (*Framework*, 37)	Incorporates the worst possible outcome. But does not overstate Entity X's liability at either balance sheet date because management's estimate also incorporates the best possible outcome and the most likely outcome of the lawsuit.	Considers all possible outcomes (including the worst possible outcome) but does not reflect the worst possible outcome in the liability recognised by Entity X on both balance sheet dates.
Completeness - necessary to achieve reliability (*Framework*, 38)	Reflects information about all possible cash outflows at both balance sheet dates.	Considers all possible outcomes but reflects information about only one possible cash flow at both balance sheet dates.
Comparability (*Framework*, 39-42)	The decrease in the estimate of Entity X's liability on 30 June 20X1 reflects the change in management's estimate of the financial position of Entity X from one period to the next.	Entity X's estimate of its liability remains unchanged. This suggests that management believes Entity X is in the same financial position on both balance sheet dates.
Understandability (*Framework*, 25)	Users may require additional information to understand the estimation technique applied by Entity X and the uncertainties	Users may require additional information to understand the estimation technique applied by Entity X and the uncertainties

Qualitative characteristic	**Current settlement notion (estimated using an expected cash flow approach)**	**Cash outflow required to settle a liability (using the individual most likely outcome)**
	associated with management's estimate of the liability on both balance sheet dates.	associated with management's estimate of the liability on both balance sheet dates.

B6. The evaluation above illustrates that both measurement principles provide useful information about Entity X's liability (although sometimes the measurement principles meet the qualitative characteristics in the *Framework* for different reasons). However, on balance, the Board believes that a measurement principle based on a current settlement notion provides superior information about Entity X's liability because an expected cash flow approach is capable of reflecting changes in facts and circumstances relating to the liability on a timely basis.