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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting:	**Wednesday 16 April, London**
Project:	**Liabilities — amendments to IAS 37**
Subject:	**Measurement Guidance (Agenda Paper 4)**

Purpose of paper

1 Paper 4A for the Board [not included with the observer note] is the first draft of possible application guidance to accompany the measurement requirements proposed in the Exposure Draft of amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. The staff expect to put more time into refining the text during the drafting stage of the project. However, the staff would like the Board to give general comments on this early draft, while the recent Board discussions on measurement are still fresh in the minds of staff and Board members.

2 Paper 4 highlights aspects of the proposed text for further discussion and approval by the Board. The content of Paper 4 is set out below. Paragraph numbers correspond to those in Paper 4.

Background

Changes previously approved by the Board

3 The Board has re-deliberated the measurement requirements and guidance proposed in the Exposure Draft of Proposed Amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* in the light of comments received. During the re-deliberations, it tentatively decided to give additional guidance on measurement:

a) to clarify that, if the amount that the entity would have to pay to settle the obligation with the counterparty is different from the amount that it would have to pay to transfer the obligation to a third party, it should measure the liability by reference to the *lower* amount[1]; and

b) to add more high-level guidance on how to estimate the current settlement/transfer amount of a liability using an expected cash flow approach[2].

Basis for decision to add more guidance

4 The decision to add more guidance was taken in the light of responses to the Exposure Draft. Comment letters indicated that:

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1 February 2008, Agenda Paper 6A

2 First tentative decision reached at September 2006 Board meeting when the Board discussed comment letters—Agenda Paper 8D. The decision was reaffirmed in January 2007 when the Board discussed feedback from the round-table meetings—Agenda Paper 4A.

a) many constituents expected to encounter difficulties measuring current settlement/transfer amounts; and

b) some constituents did not fully understand the objectives and attributes of an expected cash flow calculation. There was a risk that information would be omitted from the calculations, which would reduce the reliability of the measurements.

~~6~~5 The issue arose again at the round-table meetings. Even participants who agreed with the proposed measurement requirements said that they expected to encounter difficulties applying them in practice. Concerns mainly focused on non-contractual one-off obligations for which there was no market data or previous experience upon which to draw. Specific concerns were that:

a) complex models would be needed.

b) entities would not be able to source the information required. Would lawyers be able and willing to assign probabilities to a range of possible outcomes associated with legal proceedings?

c) auditors would be unable to verify expected value calculations, except mechanically, increasing audit risk and cost.

Previous discussions about the content of additional guidance

~~7~~6 The Board discussed the content of additional guidance in September 2006 and January 2007. It directed the staff to focus on high-level application guidance that:

a) clarified the three ‘building blocks’ of the required calculations, ie (i) probability-weighted expected cash flows, (ii) time value of money and (iii) adjustments for risk;

b) noted that the complexity of the model will vary depending on the nature of the liability;

c) required entities to give precedence to market information if available, but clarified that otherwise the entity's own assumptions would normally be used in the absence of any contradictory evidence;

d) explained the objectives and attributes of a risk adjustment; and

e) permitted risk to be reflected in either the cash flows or the discount rate.

~~8~~7 The Board also tentatively decided[3] to consider at a future meeting whether to give more guidance on:

a) the types of expenses that should be included in the measure of the liability;

b) whether possible changes in *existing* laws should be taken into account in the measurement of the liability; and

c) the possible nature of the 'extremely rare cases' in which a liability might not be capable of reliable measurement (and hence would not be recognised).

Content of this paper

~~9~~8 This paper *does not* address the issue in paragraph 7c). A future paper will revisit concerns that for a minority of liabilities—such as major, unprecedented legal claims—it may not be possible measure the current settlement/transfer amount reliably. That paper will consider whether there is a need to address such situations in the final standard.

[3] September 2006, Agenda Paper 8D.

~~10~~9 This paper *does* address the other issues raised in paragraph 7, along with further questions that have arisen during drafting. The issues are covered in the following sections:

A Layout of guidance (paragraphs 10-12)

B Whether to require objective evidence of settlement amounts (paragraphs 13-29)

C Whether to merge the measurement requirement with guidance on meaning of rationally (paragraphs 30-36)

D Reassurances about complexity (paragraphs 37 to 39)

E Guidance on the use of the entity's own estimates (paragraphs 40 to 45)

F Future changes in existing legislation (paragraphs 46 to 53)

G Relevant cash flows (paragraphs 54 to 63)

A Layout of guidance

~~11~~10 The Exposure Draft contained some guidance on applying an expected cash flow approach.

~~12~~11 The content of this guidance was largely carried forward from the existing IAS 37. So its layout was also largely unaltered. However, because the guidance is now being reviewed and expanded, the staff suggest that the Board could take the opportunity to improve its layout and structure too. Accordingly, the staff propose that:

a) the guidance on how to estimate transfer amount is placed in a separate appendix rather than in the body of the standard. The staff suggest that this approach makes the standard more readable and emphasises that the guidance is to help preparers achieve the measurement objective, not add more measurement rules; and

b) the application guidance is reordered so that it is grouped under three headings, one for each of the 'building blocks' ie (i) estimates of cash flows, (ii) time value of money and (iii) adjustments for risk.

Question for the Board

~~13~~12 Board members will be asked whether they agree with the proposed changes to the layout.

B Whether to require objective evidence of settlement amounts

The issue

~~14~~13 At the February 2008 meeting[4], the Board considered the following text to explain the meaning of the word 'rationally' in the measurement requirement:

> The amount that an entity would rationally pay to settle or transfer an obligation is the least cost amount, that is:
>
> (a) the amount that a third party would demand to assume the obligation; or
>
> (b) the amount that the counterparty would demand to settle the obligation, if there is objective evidence that this amount is lower than (a).

4 Agenda Paper 6A

~~15~~14 The Board approved this wording (subject to additional guidance emphasising that in many situations the liability will be estimated on the basis of the entity's own assumptions about the future cash flows).

~~16~~15 However, the Board's discussion during the meeting focused on one aspect of the wording, ie the proposal that the liability should be measured at the *lower* of settlement or transfer amount. There was no discussion of another aspect of the wording, ie the proposal to focus on transfer amount, with settlement amount being used only if there is 'objective evidence' that it is lower than transfer amount.

~~17~~16 The staff think that this is a significant feature of the proposed wording. So the staff wish the Board to confirm explicitly that it is happy with this aspect of the wording. The following paragraphs explain why the staff proposed it at the February meeting.

Reason for requiring objective evidence of settlement amounts

~~18~~17 During small-group meetings with Board members in January, several Board members expressed concerns about measurements of settlement amounts.

~~19~~18 One concern was that the counterparties to some obligations (eg plaintiffs in lawsuits) do not necessarily base their decisions on informed assessments of the expected cash flows and the time value of money. Counterparties could have a range of motivations and attitudes to settlement. It could be difficult to second-guess the amount the counterparty would demand to settle the obligation, or even to define in principle what the counterparty should *rationally* demand. It is easier to define (and hence estimate) the amount that a *third party* would rationally demand to assume the obligation—the third party would be putting itself into the same position as the entity and rationally would take into account the same factors as the entity (ie range of possible outcomes, time value of money and risk).

~~20~~19 Some Board members also indicated that they might view with scepticism estimates of settlement amounts that were significantly less than estimates of transfer amounts. A transfer amount takes into account the expected cash flows for the range of possible outcomes. If the entity could settle the liability with the counterparty for less than this amount, why would it not have done so before now?

~~21~~20 Given these concerns, it could be argued that a liability should be measured at less than estimated transfer amount only if there is objective evidence (such as a written offer from the counterparty) that the settlement amount is lower.

21 If this approach were to be taken, entities would never need to estimate settlement amounts in the absence of such evidence:

- if the settlement amount were estimated to be higher than transfer amount, it would not be relevant for measurement purposes, and
- if the settlement amount were estimated to be lower than transfer amount, it could not be used because of the absence of objective evidence.

Advantages of requiring objective evidence of settlement amounts

22 The staff think that requiring objective evidence of settlement amounts would have three advantages:

a) it would help prevent measurements based on unreliable estimates of settlement amounts;

b) it would make the measurement requirements easier to apply. Preparers would not routinely have to estimate two different amounts to identify the lower one—they would have to consider settlement only if they could obtain objective evidence of settlement amount; and

c) guidance on estimating the liability using expected cash flow approaches would be necessary only for estimates of transfer amounts. It would thus be shorter and more straightforward.

Disadvantages of requiring objective evidence of settlement amounts

23 The proposed wording might be viewed as adding a new constraint on the measurement basis, which would change the proposed measurement requirements (and possibly require exposure for comment). However, it could be argued that the additional constraint would prevent the use of settlement amounts only if they had been estimated using optimistic assumptions that were not supported by objective evidence—which should not happen anyway. In other words, the proposed wording does not change the requirements—it just applies the general principle that assumptions ought to be reasonable and supportable.

Staff recommendations

24 On the basis of the arguments in paragraph 22, the staff will recommend that the measurement requirement should focus on transfer amount, with settlement amount being used only if there is objective evidence that it is lower than transfer amount.

25 Therefore the staff will recommend that the Board reaffirms the wording proposed in paragraph 13 and gives guidance on applying expected cash flow approaches only for estimates of transfer amounts. The guidance in Paper 4A has been drafted on the assumption that this recommendation is accepted.

26 The staff have also drafted a sentence in Paper 4A giving examples of ‘objective evidence’. This sentence could be included if the Board thinks that guidance is needed about the meaning of ‘objective evidence’..

Questions for the Board

27 Board members will be asked whether they are happy to state explicitly that liabilities should be measured at settlement amount only when such amounts are supported by objective evidence.

28 Board members will be asked whether they agree that, if objective evidence were to be required for settlement amounts, guidance on estimating liabilities using an expected cash flow approach needs to cover only estimates of *transfer* amounts.

29 Board members will be asked whether they think that examples of objective evidence should be given, as proposed in paragraph 29B of the Paper 4A.

C Whether to merge the measurement requirement with guidance on meaning of rationally

30 At the February meeting, the staff proposed adding the guidance on the meaning of the word ‘rationally’ immediately after the measurement requirement. The standard would thus read:

> **29 An entity shall measure a liability at the amount that it would rationally pay on the measurement date to settle the present obligation with the counterparty or to transfer it to a third party.**[5]
>
> 29A The amount that an entity would rationally pay to settle or transfer an obligation is the least cost amount, that is:
>
> (a) the amount that a third party would demand to assume the obligation; or
>
> (b) the amount that the counterparty would demand to settle the obligation, if there is objective evidence that this amount is lower than (a).

31 A Board member suggested that these two paragraphs could be merged to create a single requirement.

32 The paragraphs could be merged in the following way:

> **29 An entity shall measure a liability at the amount that it would rationally pay on the measurement date to <u>be relieved of the present obligation</u> ~~settle the present obligation with the counterparty or to transfer it to a third party.~~<u>.</u>**
>
> ~~29A The amount that an entity would rationally pay to settle or transfer an obligation is the least cost amount, that is:~~ **<u>That amount is:</u>**
>
> **(a) the amount that a third party would demand to assume the <u>present</u> obligation; or**
>
> **(b) the amount that the counterparty would demand to settle the <u>present</u> obligation, if there is objective evidence that this amount is lower than (a).**

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5 As proposed in Exposure Draft, with drafting amendments approved by the Board in February 2008 (Agenda Paper 6A, paragraphs 15-20).

33 A possible disadvantage of merging the two paragraphs in this way is that the new wording is less obviously the same as the requirement in the existing IAS 37, which refers to the liability being measured at 'the amount that an entity would rationally pay to settle the obligation at the balance sheet date or to transfer it to a third party at that time'[6]. The Board has been able to point to similarity between paragraph 29 of the Exposure Draft and paragraph 37 of IAS 37 to support its assertions that the Exposure Draft proposals sought to clarify, not change, the existing measurement requirements.

34 However, the staff agree that merging the two paragraphs streamlines the requirements. And the staff note that the derivation of the proposed new requirements from paragraph 37 of the existing IAS 37 would be fully explained in the basis for conclusions.

35 Therefore, the staff will recommend merging the requirements as proposed in paragraph 32 above, and have drafted the text in Paragraph 4A accordingly.

Question for the Board

36 Board members will be asked whether they agree that the requirements should be merged as proposed in paragraph 32.

6 IAS 37, paragraph 37.

D Reassurances about complexity

37 As noted in the background section of this paper, one of the reasons for giving more guidance on applying expected cash flow approaches is to demonstrate that the calculations envisaged by the Board are not necessarily as complex as some constituents seem to think.

38 The Board decided that the guidance should state that the complexity of the calculations will depend on the nature of the obligation. The staff suggest expanding on this statement by including one or all of:

a) a sentence from IAS 36 *Impairment of Assets* acknowledging that in some cases an entity may not be able to develop more than general statements about the variability of cash flows (paragraph AG7 in Paper 4A);

b) an example to show how simple the calculation of expected value might be if information is limited (paragraph AG8); and

c) further reassurances taken from the guidance on applying expected present value techniques in Appendix B to FASB Statement 157 *Fair Value Measurements* (paragraph AG9).

Question for the Board

39 Board members will be asked whether they think that this guidance is helpful.

E Guidance on the use of the entity's own estimates

40 At the February meeting, the Board decided that the guidance should emphasise that, in practice, liabilities within the scope of IAS 37 will often be measured using the entity's own estimates of future cash flows.

41 Guidance about using the entity's own estimates is included in both SFAS 157 and FASB Statement of Financial Accounting Concepts 7: *Using Cash Flow Information and Present Value in Accounting Measurements* ('CON 7').

42 Paragraph 30 of SFAS 157 states that:

> Unobservable inputs shall be developed based on the best information available in the circumstances, which might include the reporting entity's own data. In developing unobservable inputs, the reporting entity need not undertake all possible efforts to obtain information about the market participant assumptions. However, the reporting entity shall not ignore information about market participant assumptions that is reasonably available without undue cost and effort. Therefore, the reporting entity's own data used to develop unobservable inputs shall be adjusted if information is reasonably available without undue cost and effort that indicates that market participants would use different assumptions.

43 Paragraph 38 of CON 7 states that:

> Adopting fair value as the objective of present value measurements does not preclude the use of information and assumptions based on the entity's expectations. As a practical matter, an entity that uses cash flows in accounting measurements often has little or no information about some or all of the assumptions that marketplace participants would use in assessing the fair value of an asset or liability. In those situations, the entity must necessarily use the information that is available without undue cost and effort in developing cash flow estimates. The use of an entity's own assumptions about future cash flows is compatible with an estimate of fair value, as long as there are no contrary data indicating that marketplace participants would use different assumptions. If such data exist, the entity must adjust its assumptions to incorporate that market information.

44 The staff think that SFAS 157 and CON 7 are saying roughly the same thing. However, staff think the drafting in CON 7 is clearer and well-aligned with the message that the Board wishes to convey in IAS 37. The staff have therefore proposed draft text based on that in CON.7. (Paragraph AG14 in Paper 4A.)

Question for the Board

45 Board members will be asked whether they are happy with the wording of paragraph AG14.

F Future changes to existing legislation

46 The Exposure Draft stated that:

> **41 When measuring a non-financial liability, an entity shall reflect the effects of future events that may affect the amount that will be required to settle the obligation.**
>
> 42 Only the effects of future events that may affect the amount that will be required to settle an obligation without changing the nature of the obligation are reflected in the measurement of a non-financial liability. For example, an entity's past experience may indicate that the cost of cleaning up a site at the end of its life may be reduced by future changes in technology. Accordingly, when measuring the liability, the entity reflects an assessment of both the assumed effects of the future technology on the cost of cleaning up the site and the likelihood that such technology will be available. In contrast, the effects of future events that create new obligations (or change or discharge existing obligations) are not reflected in the measurement of a liability. *For example, the effects of possible new legislation are not reflected in the measurement of a liability because they create or change the obligation itself.* (Emphasis added.)

47 The Basis for Conclusions explained this guidance using an example that involved a possible *change in existing* legislation rather than entirely *new* legislation:

> BC88 … Accordingly, an entity that has an existing legal obligation to clean up contamination in a country in which the government is considering amending the law and requiring a higher standard of clean-up, should treat the change in the law as changing the nature of the underlying obligation. Therefore, it gives rise to a new obligation rather than changing the amount required to settle the existing obligation.

48 In September 2006, the Board tentatively decided to reconsider whether a possible change in existing legislation should be regarded in the same way as new legislation (ie creating or changing the obligation) or as a future event that would affect the measurement of the existing obligation.

49 An argument put forward for the latter treatment is that a possible change in existing legislation (eg a possible tightening of environmental clean-up legislation) would affect the amount that the entity would rationally pay to be released from the present obligation.

50 However, the counter arguments could be that:

a) the possibility of new legislation would have exactly the same effect—there is no difference between new legislation and a change in existing legislation;

b) if the objective is to measure the present obligation, the measurement should be based on the present legislation. A possible future tightening of legislation would not affect the amount that the entity would rationally pay to be relieved of the *present obligation*. Rather it would give rise to a further amount that the entity would rationally pay to be relieved of the *risk* that this obligation would change in future. This risk is not in itself a present obligation.

Staff recommendation

51 On the basis of the arguments in paragraph 50, the staff think that a possible change in an existing law should be treated in the same way as the possible introduction of a new law and that only minor drafting amendments are necessary to clarify that this was the intention of the guidance in the Exposure Draft.

52 The staff will suggest that the following amendments would be sufficient to make this point clear:

> 42 … For example, the effects of <u>a</u> possible <u>introduction of</u> new legislation <u>or change in existing legislation</u> are not reflected in the measurement of a liability because they create or change the obligation itself.

Question for the Board

53 Board members will be asked whether they agree that in IAS 37, possible future changes in existing legislation should be treated in the same way as possible new legislation and that the drafting amendments proposed above would make this point clearer.

G Relevant cash flows

54 In September 2006, the staff recommended that the Board consider further whether to give more guidance on the cash flows that should be included in the expected cash flow calculations. The Board did not debate issue at that meeting, but decided to come back to it at a later date.

55 Respondents and round-table participants had requested guidance on:

a) whether an entity that expects to settle a liability using internal resources should include only the incremental cash outflows or also an allocation of fixed costs and overheads; and

b) whether expenses associated with settling a present obligation—such as legal fees incurred defending a law suit—should be included in the measure of the obligation.

Existing precedents

56 No guidance was given in the Exposure Draft itself. However, guidance was given for lawsuits in Illustrative Example 1 accompanying the Exposure Draft.

57 The message in this guidance is that the relevant cash flows include all expenses that a third party would take into account in determining how much it would demand to assume the liability. A similar message is included in FASB Statement No. 143 *Accounting for Asset Retirement Obligations*. The implementation guidance states that in estimating the expected cash flows, the entity should develop assumptions about:

a) the costs that a third party would incur in performing the tasks necessary to retire the asset; and

b) other amounts that a third party would include in determining the price of the transfer, including, for example, inflation, overhead, equipment charges, profit margin and advances in technology.

58 The Board's insurance discussion paper[7] gives more detailed guidance regarding the cash flows that would be relevant for estimates of current exit price. Paragraph E24

[7] Discussion Paper *Preliminary Views on Insurance Contracts*, May 2007

lists relevant cash flows. Many of these are specific to insurance contracts. However, stated more generally, they include [list omitted from the observer note].

59 Paragraph E25 goes on to list cash flows that would not be relevant. These include [list omitted from observer note].

Staff conclusions and recommendations

60 IAS 37 will require liabilities to be measured at a transaction price, ie the amount that the entity would rationally pay today to transfer or settle its obligation. The staff note that an advantage of measurements based on transaction prices (rather than accumulations of future costs) is that the measurement objective is clear, and hence that less guidance is needed on how to apply the measurement requirements. The guidance can be relatively simple—the calculations should take into account all the cash flows that a third party would take into account when pricing the transaction, and nothing else. Therefore the staff conclude that constituents' concerns could be addressed by clarifying this point and giving a few general examples—detailed guidance is neither necessary nor desirable.

61 The text proposed by the staff is in paragraphs AG11 and AG12 of Paper 4A.

Questions for the Board

62 Board members will be asked whether they agree that IAS 37 should stress the overall objective rather than attempt to give detailed guidance.

63 Board members will be asked whether they are happy with the wording proposed in paragraphs AG11 and AG12.

H General comments on the guidance

64 As requested by the Board, the staff have aimed to develop high-level guidance that gives readers a clearer understanding of the objective of the calculations and the broad steps required to achieve the objective. The staff have sought in particular to demonstrate that for many liabilities within the scope of IAS 37, the calculations need not be complex and will be based on the entity's own estimates of future cash flows. The staff also hope that the guidance demonstrates the logic of taking into account all possible outcomes—not just the most likely one.

65 For technical content, the staff have drawn on existing literature, namely:

a) the Board's discussion paper *Preliminary Views on Insurance Contracts*, published in May 2007.

b) CON 7.

c) Appendix B to SFAS 157. (Guidance on using present value techniques.)

d) Appendix A to IAS 36 *Impairment of Assets*. This appendix draws on CON 7 to give guidance on using present value techniques (including expected present value) to measure value in use.

66 However, the proposed text does not does not address all matters covered in these other documents — only those previously identified by the Board, as listed in paragraphs 6 and 7(a)-(b) above. By limiting the guidance to these matters, the staff think that the Board will not be adding anything that would in itself necessitate re-exposure of the draft standard.

Question for the Board

67 Board members will be asked whether they have any other comments on the draft text.