IASB Meeting

Staff Paper

Agenda reference **8A - APPENDIX**

Date **April, 2009**

Project **Liabilities—amendments to IAS 37**

Topic **Draft measurement guidance**

This paper sketches how the IAS 37 measurement requirements and guidance could be drafted if the Board decides to address only the matters recommended by the staff in Paper 8A.

The text is based on the Exposure Draft text. Proposed insertions and deletions are marked. But movements of text from the body of the standard to application guidance, and reordering within the application guidance, are not marked. Instead, the old paragraph numbers, and other explanatory notes, are shown in comment balloons.

PROPOSED TEXT FOR BODY OF STANDARD

~~Amount that an entity would rationally pay to settle or transfer the obligation~~

29 An entity shall measure a ~~non-financial~~ liability at the amount that it would rationally pay at the end of the reporting period to be relieved of the present obligation, ie to settle ~~the present obligation~~ it or to transfer it to a third party ~~on the balance sheet date~~.

29A Appendix [X] contains guidance on estimating this amount.

30…42 [Paragraphs 30-42 moved to application guidance – see appendix.]

Subsequent measurement

43 The entity shall review the carrying amount of a ~~non-financial~~ liability at ~~each balance sheet date~~ the end of each reporting period and adjust it to reflect the current amount that the entity would rationally pay to ~~settle the present obligation or to transfer it to a third party~~ be relieved of the present obligation ~~on that date~~.

44 ~~An entity subsequently remeasures a non-financial liability in accordance with paragraphs [30-42]. Therefore, remeasurement reflects any changes in:~~

~~(a) the expected amount and timing of the economic benefits that will be required to settle the obligation;~~

~~(b) the risks and uncertainties surrounding the obligation; and~~

~~(c) the discount rate used to measure the liability.~~

Comment [jmb1]: The staff suggest this deletion because all discussion of risks and discounting is now in the appendix.

45 Changes in the carrying amount of a ~~non-financial~~ liability resulting from the passage of time are recognised as a borrowing cost.

PROPOSED TEXT FOR APPLICATION GUIDANCE

Appendix [X]
Application guidance

This appendix is an integral part of the standard

Measurement

Use of estimates

AG1 The standard requires an entity to measure a liability at the amount it would rationally pay at the end of the reporting period to be relieved of the present obligation, ie to settle it or to transfer it to a third party.

AG2 An entity would rationally pay the lowest amount that it would be required to pay to settle or transfer the present obligation. In some cases, contractual or other market evidence can be used to determine this ~~the~~ amount ~~that would be required to settle or transfer the obligation on the balance sheet date~~. However, in many cases, observable market evidence ~~of the amount that the entity would rationally pay to settle the obligation or to transfer it to a third party~~ will not exist and the amount must be estimated.

Comment [j2]: Paragraph 30 in Exposure Draft.

AG3 Such estimates would take into account:

a) the future cash flows expected to be required to fulfil the obligation;

b) the time value of money; and

c) the effects of uncertainty about the future cash flows.

AG4 Factors (a) and (b) can be taken into account by estimating the 'expected present value' of the future cash flows required to fulfil the obligation (see paragraphs AG5-AG21). Factor (c) can be taken into account by adjusting the expected present value for risk (see paragraphs AG22-AG24).

Expected present value

AG5 If the amount or timing of the future cash flows is uncertain, various outcomes are possible. All foreseeable outcomes affect the amount the entity would rationally pay to be relieved of the present obligation. The more likely it is that any particular outcome will occur, the greater the effect that outcome will have on the amount that the entity would rationally pay.

AG6 The range of outcomes and their effects are taken into account by estimating their expected present value. Estimating the expected present value involves:

a) identifying each possible outcome;

b) making an unbiased estimate of the amount and timing of the future cash flows for that outcome (see paragraphs AG12-AG19) and determining the present value of these cash flows (see paragraphs AG20-AG21); and

c) making an unbiased estimate of the probability of each outcome.

The expected present value is the probability-weighted average of the present values of the possible outcomes.

Comment [C3]: Adapted from paragraph 40 of insurance discussion paper.

~~31 The basis of estimating many non-financial liabilities will be an expected cash flow approach, in which multiple cash flow scenarios that reflect the range of possible outcomes are weighted by their associated probabilities. An expected cash flow approach is an appropriate basis for measuring both liabilities for a class of similar obligations and liabilities for single obligations. This is because it is likely to be the basis of the amount that an entity would rationally pay to settle the obligation(s)~~

~~or to transfer the obligation(s) to a third party on the balance sheet date. In contrast, a liability for a single obligation measured at its most likely outcome would not necessarily represent the amount that the entity would rationally pay to settle or to transfer the obligation on the balance sheet date.~~

AG7 ~~When an entity is estimating~~ Thus, if the the amount of a ~~non-financial~~ liability ~~that is contingent~~ is conditional on the occurrence (or non-occurrence) of one or more uncertain future events, the measurement of the liability reflects the uncertainty about these ~~the future~~ event~~(~~s~~)~~. ~~For example, in estimating a liability for a product warranty obligation, an entity considers the likelihood of claims under the warranty occurring and the amount and timing of the cash flows that would be required to meet those claims.~~

AG8 The entity uses all available information. In some cases, an entity may have access to extensive data and may be able to identify many cash flow outcomes. In other cases, the information available to the entity might be more limited.

AG9 Suppose, for example, that an entity has a single obligation. The only information available to management might provide evidence that:

- the most likely cash outflow is approximately 100 currency units (CU100), but that there is a possibility that the outflows could be as high as CU250 or as low as C50; and
- the most likely outcome is approximately twice as likely as the worst-case outcome, and the best-case outcome has only a 1 in 10 chance of occurring.

Using this information, management would estimate the liability using three possible outcomes:

Comment [jmb4]: Paragraph 31 in the Exposure Draft. The staff have proposed to replace the first half with the two preceding paragraphs, which are more explicit about what the entity should do. The staff further propose to incorporated the second half into the Basis for Conclusions rather than application guidance, because it explains *why* the Board has included the requirements, not *what* the requirements are.

Comment [jmb5]: Paragraph 33 in Exposure Draft. The reference to warranty obligations is excluded because such obligations will ultimately fall within the scope of the revernue standard.

Comment [C6]: Based on a sentence in paragraph A12 in the appendix to IAS 36. But the rest of paragraph A12, which discusses cost-benefit considerations, has not been included. If the Board wishes a discussion of cost-benefit considerations, this could be added.

Cash flow	Probability
CU50	10%
CU100	60%
CU250	30%

AG10 Even if there is evidence to support many possible outcomes, it is not always necessary to consider distributions of literally all possible cash flows using complex simulations. It may be possible to develop a limited number of discrete outcomes and probabilities that capture the array of possible cash flows.

Comment [C7]: From paragraph B17 of the appendix on present value techniques accompanying SFAS 157.

AG11 The uncertainties about the amount or timing of the outflow of economic benefits are disclosed ~~in accordance~~ to comply with paragraph [68(c)].

Comment [jmb8]: Paragraph 37 in Exposure Draft.

Estimates of future cash flows

Overall principles

AG12 The estimates of cash flows should:

a) incorporate, in an unbiased way, all available information about the amount, timing and uncertainty of the relevant future cash flows.

b) be current, ie correspond to conditions at the end of the reporting period.

c) be consistent with observable market prices, if such prices are available.

Relevant future cash flows

AG13 The relevant future cash flows are those that affect the amount that the entity would rationally pay to be relieved of the present obligation.

AG14 If the obligation is of a type that is fulfilled by making payments to the counterparty, the relevant cash flows include:

a) the amounts that are expected to be paid to the counterparty; and

b) associated costs, such as legal fees.

AG15 If the obligation is of a type that is fulfilled by undertaking a service, the relevant cash flows include the amounts that the entity would rationally pay a contractor to undertake the service on its behalf.

AG16 The relevant cash flows do not include income tax payments and receipts because these are recognised separately to comply with IAS 12 *Income Taxes*. ~~The non-financial liability is measured before tax, because the tax consequences of the liability, and changes in it, are accounted for in accordance with IAS 12.~~

Comment [jmb9]: Paragraph 34 in the Exposure Draft. The revised wording is more consistent with a cash flow terminology and is based on the wording in paragraph E25(e) of the insurance discussion paper.

Sources of evidence

AG17 The estimates of the amount, timing and probability of the future cash flows ~~outcome and financial effect~~ are determined by the judgement of the management of the entity, supplemented by experience with similar transactions and, in some cases, reports from independent experts. The evidence considered includes any additional information provided by events after the ~~balance sheet date~~ reporting period, but only to the extent that the information relates to the obligation existing at the ~~balance sheet date~~ end of the reporting period.

Comment [jmb10]: Paragraph 32 in Exposure Draft.

Future events

AG18 The entity takes into account ~~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~~ fulfil the present obligation. 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~~ estimating the expected cash flows, the entity reflects in the range of possible outcomes 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.

Comment [jmb11]: Paragraph 41 in Exposure Draft

Comment [jmb12]: From the middle of paragraph 42 in the Exposure Draft

AG19 Only the effects of future events that may affect the amount that will be required to ~~settle~~ fulfil ~~an~~ the present obligation without changing the nature of the obligation are reflected in the estimates of future cash flows ~~measurement of a non-financial liability~~. In contrast, the effects of future events that create new obligations (or change or discharge existing obligations) are not reflected in the estimates of future cash flows ~~measurement of a liability~~. For example, the effects of a possible introduction of new legislation or change in existing legislation are not reflected in the measurement of a liability because they create or change the obligation itself.

Comment [jmb13]: The rest of paragraph 42 in the Exposure Draft.

Present value

AG20 Because of the time value of money, ~~estimated~~ cash outflows that arise soon after the balance sheet date are more onerous than those of the same amount that arise later. Therefore, cash flows are discounted to their present value.

Comment [jmb14]: Paragraph 39 in Exposure Draft.

AG21 ~~When an entity measures a non-financial liability using an estimation method that involves projections of future cash flows, it shall discount the cash flows using~~ The expected cash flows are discounted at a ~~pre-tax~~ rate (or rates) that reflect(s) current market assessments of the time value of money ~~and the risks specific to the liability~~.

~~Risks and uncertainties~~ Risk adjustment

~~35 In measuring a non-financial liability in accordance with paragraph 29, an entity shall include the effects of risks and uncertainties.~~

AG22 Risk describes variability of outcome. A risk adjustment typically increases the amount at which a liability is measured relative to a measurement that does not include a risk adjustment, all other things being equal. This is because it reflects the price that entities demand for the uncertainties and unforeseeable circumstances inherent in the liability.

AG23 A risk adjustment may be included by

a) adjusting estimates of the cash flows,

b) adjusting the rate used to discount the expected cash flows to their present values, or

c) first calculating the expected present value of the cash flows and adding a risk adjustment to the amount so calculated.

The most appropriate method depends on the nature of the risk and the pattern of the estimated future cash flows. ~~When an entity reflects the effects of risks and uncertainties~~ If the risk adjustment for an obligation is included by adjusting the discount rate ~~rather than by adjusting the estimated cash flows~~, the ~~resulting~~ adjusted discount rate is typically lower than a risk-free rate.

AG24 Caution is needed in making judgements under conditions of uncertainty, so that liabilities are not understated. However, uncertainty does not justify deliberate overstatement of liabilities. Care is needed to avoid duplicating adjustments for risk ~~and uncertainty~~ with consequent overstatement of ~~a non-financial~~ the liability.

Comment [jmb15]: Paragraph 38 in the Exposure Draft. The reference to including risk in the discount rate is deleted here because it is covered in the section on risk below. It is clearer there that risks are reflected in the discount rate only if not reflected in the cash flows.

Comment [C16]: Paragraph 35 in Exposure Draft. The requirement to take account of risk is already stated in AG3.

Comment [jmb17]: First part of paragraph 36 in Exposure Draft

Comment [jmb18]: The Board asked the staff to state that risk could be reflected in either the discount rate or the cash flows. The staff have suggested the subsequent sentence to alert preparers to the fact that in some circumstances, adjusting the discount rate might not be appropriate. More detail is given in paragraph F9(h) of Appendix F to the insurance discussion paper.

Comment [jmb19]: Paragraph 40 in the Exposure Draft.

For example, if the ~~projected costs of~~ estimated cash outflows for a particularly adverse outcome are increased to take account of risk, ~~estimated at the high end of the range of those reasonably expected,~~ that outcome is not then ~~deliberately~~ also treated as more probable than is realistically the case. Similarly, ~~The~~ discount rate~~(s)~~ ~~shall~~ does not reflect risks for which future cash flow estimates have been adjusted.*

Comment [jmb20]: Second half of paragraph 36 in the Exposure Draft, with some rearrangement of the sentences.

Comment [jmb21]: Last sentence of paragraph 38 in Exposure Draft. The staff propose to delete the footnote because relevant guidance in IAS 36 is also now in this appendix.

~~* Further guidance on using cash flow information and present value in accounting measurements is contained in Appendix A of IAS 36 *Impairment of Assets*.~~