Project	**Liabilities—amendments to IAS 37**
Topic	**Measurement issues**

Aim of meeting

1. The aim of the meeting is to decide how much measurement guidance to include in the revised IAS 37.

Summary of staff recommendations

2. The staff recommend that the Board should finalise the guidance on measurement without resolving all the unresolved matters that have been raised for discussion at previous meetings. In other words, the additional guidance should address only those matters on which the Board has reached agreement at previous meetings.

3. Accordingly, the guidance would be based on that proposed in Exposure Draft, supplemented with:

This paper has been prepared by the technical staff of the IASB for the purposes of discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper and do not purport to represent the views of any individual members of the Board or the IASB.

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(a) more (high-level) guidance to explain the 'building blocks' and mechanics of expected cash flow estimation techniques, and reassure constituents that the calculations will not necessarily be as complex as they might fear.

(b) clarification that the standard does not allow a choice of two different measurements for liabilities. An entity would *rationally* pay the lowest amount that it would be required to pay to settle or transfer the present obligation.

4. The staff further recommend that the guidance also specifies that if an entity uses an expected cash flow approach to estimate a service obligation, such as an asset retirement obligation, the relevant cash flows are the amounts the entity would rationally pay a contractor to undertake the service.

Overview of paper

5. This paper explains the reasons for the staff recommendations. In summary, the reasons are that:

(a) the Board should finalise the revisions to IAS 37 as quickly as possible. (Paragraphs 6-10)

(b) to do so, it must finalise the measurement requirements and guidance in the next couple of months. In that time, the staff think it is unlikely that the Board will resolve all the matters that have been raised for discussion. (Paragraphs 11-17)

(c) but the Board could achieve significant improvements to the existing measurement requirements without resolving these matters. (Paragraphs 18-25)

Reasons for staff recommendations

The Board should finalise the revisions to IAS 37 quickly

6. The staff think that there are several reasons why the Board should finalise the requirements of IAS 37 as quickly as possible.

7. First, the Board is under pressure to reduce the number of projects on its agenda. The project to amend IAS 37 is a candidate for removal because of the time that has already elapsed since the Board published an Exposure Draft (in 2005). The project is starting to look like one that the Board can't complete.

8. However, the staff think the only significant matter delaying completion at present is a desire among Board members to specify more precisely the measurement objective in IAS 37—a desire that is difficult to fulfil because there are two different views among Board members about which aspect of the measurement requirement (settlement or transfer) the Board should emphasise. Arguably the Board should not let this matter delay the project—perfecting the measurement requirements was not one of the original aims of this project.

9. If the Board removed this project from its agenda, it would lose the opportunity to make the worthwhile improvements to IAS 37 that it proposed in the Exposure Draft. These include:

   (a) *removing the probability recognition criterion.* At present, IAS 37 requires entities to recognise liabilities only if it is probable that there will be an outflow of economic benefits. This requirement is inconsistent with the recognition requirements for liabilities in other standards—such as IAS 39. In particular, it is inconsistent with the requirements in IFRS 3 *Business Combinations*, which does not apply the probability recognition criterion for contingent liabilities that an entity acquires in a business combination.

(b) *removing the term 'contingent liability' and updating guidance on identifying liabilities.* The guidance in IAS 37 on identifying liabilities is unclear. IAS 37 uses the term 'contingent liability' to describe various things, some of which are liabilities and some of which are not liabilities. The proposed revisions would remove the label 'contingent liability' and focus solely on whether an item does or does not meet the definition of a liability. They would also include more guidance to help entities to identify liabilities – particularly for situations in which the outcome is dependent on the occurrence or non-occurrence of future events. The concepts and terminology developed in the Exposure Draft are consistent with those now being used in other projects, such as revenue recognition and insurance.

(c) *improving the general guidance on identifying constructive obligations and hence the specific requirements for restructuring liabilities.* The Board proposes to tighten the definition of constructive obligations by specifying that entities must have a present duty or responsibility to another party who will benefit from the entity's performance of its duty or responsibility. This additional guidance should make it easier for entities to distinguish between constructive obligations and economic compulsion, and align IFRSs more closely with US GAAP.

In particular, by tightening the definition of a constructive obligation, the Board can change the requirements for recognising liabilities for restructuring costs. The change will improve a weak area of IAS 37 and eliminate the main differences between IAS 37 and US accounting standard FAS 146 *Accounting for Costs Associated with Exit or Disposal Activities*.

(d) *clarifying that entities should measure* all *liabilities on the basis of expected value, not most likely outcome.* At present the guidance in IAS 37 is ambiguous. It is widely interpreted as permitting entities to measure single obligations at their most likely outcome.

(e) *making a range of other minor improvements*, for example removing outdated terminology (eg 'provisions'), clarifying that IAS 37 applies to all liabilities that are not within the scope of other standards and adding guidance on identifying and measuring onerous contracts.

10. A final reason for finishing this project quickly is that the longer it goes on, the more complicated the process for completing it will become. New Board members with limited understanding of the history of the project will gradually take the place of existing Board members.

It is unlikely that the Board will resolve all measurement matters quickly

11. The staff think that the Board will find it difficult to resolve quickly all matters that it has previously raised for discussion.

12. These matters have arisen while the Board has sought to address constituent concerns that the measurement requirements proposed in the Exposure Draft would be difficult to apply in practice. The Board decided to clarify the measurement objective and explain more fully how entities could apply the requirements.

13. However, while developing this guidance, it has emerged that Board members, although agreeing on many matters, have different views on whether the guidance should place more emphasis on settlement or transfer of the liability.

14. One group of Board members would prefer to emphasise the transfer notion. Broadly, they tend to think that:

- ‘settle’ means ‘cancel’.
- in the absence of evidence of a cancellation price, the entity should estimate a transfer price.
- a transfer price is not necessarily any more difficult to estimate than a fulfilment price. Problems such as information asymmetry can be avoided by specifying that the third party has the same information about, and control over, the present obligation as the entity has. The transfer price (like a ‘level 3’ fair value) can be estimated using the entity’s own data if there is no reasonably available information that indicates that market participants would use different assumptions.

15. The other group of Board members would prefer to emphasise a fulfilment notion. Broadly, they tend to think that:

- ‘settle’ means ‘fulfil’.
- transfer amounts are relevant only for obligations that the entity realistically could transfer.
- otherwise, the entity should seek the amount that it would rationally pay at the end of the reporting period to *fulfil* the present obligation.
- this is how the existing measurement requirements in IAS 37 are interpreted in practice. Other paragraphs of the existing measurement requirements also suggest that the objective is a fulfilment amount, rather than a cancellation/transfer price[1]. The scope of this project is to clarify, not change the existing measurement requirements. It would be disingenuous of the Board to require entities to measure liabilities at a cancellation/transfer price (essentially fair value) and claim that it is not changing the existing measurement requirements.

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1 For example, paragraph 45 of IAS 37 states that ‘where the effect of the time value of money is material, the amount of a provision shall be the present value of the expenditures expected to be required to settle the obligation.’

16. The staff realise that most Board members would like to resolve these matters, and to resolve them in a manner consistent with developments in liability measurement in other projects.

17. However, the staff think that the Board would struggle to achieve these objectives in the short term. There is substantial support among Board members for each of the two views put forward in paragraphs 14 and 15. And it would be difficult for the Board to achieve consistency across projects while operating under the constraint that it can clarify but not change the existing measurement requirements in IAS 37. The staff have already started considering liability measurement on a cross-cutting basis. But this is unlikely to provide a solution in the very near future. A fundamental review of the measurement requirements of IAS 37 might be worthwhile in the future, but it is not within the scope of this project.

The Board could achieve significant improvements without resolving these issues

18. Finally, the staff suggest that the Board could substantially improve the existing measurement requirements and guidance in IAS 37 without resolving the issues raised in the last section.

Improvements proposed in the Exposure Draft

19. The Exposure Draft proposals alone would achieve significant improvements by:

    (a) clarifying that the objective is to measure what the entity would pay today to be relieved of the present obligation;

    (b) clarifying that, consistent with this objective, liabilities should be estimated on the basis of their expected present values, not their most likely outcome;

    (c) removing terminology (such as ‘best estimate’) and guidance that might suggest that the measurement objective is to predict the most likely outcome.

Further improvements already approved by the Board

20. Further improvements could be achieved by making additional changes already approved by the Board, ie to:

 (a) give more (high-level) guidance to explain the 'building blocks' and mechanics of expected cash flow estimation techniques, and reassure constituents that the calculations will not necessarily be as complex as they fear. This guidance could state that in the absence of market data, entities will use their own data to estimate the future cash flows required to fulfil the obligation. Whatever Board members think the measurement objective should be, they agree that entities will in practice need to measure liabilities within the scope of IAS 37 using estimates of their own future cash flows.

 (b) clarify the meaning of the word 'rationally' in the measurement requirement. An entity would rationally pay the lowest amount that it would be required to pay to be relieved of the present obligation. In other words, the standard does not allow a choice of measurement objective (settle or transfer).

Additional guidance for 'service' obligations

21. Finally, the Board could give more guidance on measuring obligations, such as asset retirement obligations, that entities fulfil by undertaking a service rather than paying the counterparty. The Board could specify that, if an entity uses an expected cash flow approach to estimate such an obligation, the relevant cash flows are the amounts the entity would rationally pay a contractor to undertake the service. Specifying the relevant cash flows in this way would overcome problems in defining which costs should be included (eg to what extent overheads should be included) and whether and how the estimate of the liabilities should include a service margin.

22. The Board discussed the possibility of specifying the relevant cash flows in this way in April 2008. Although the Board reached no firm decisions at that meeting, several Board members expressed support for the idea.

23. It could be argued that a requirement to measure service obligations by reference to the amounts that the entity would rationally pay a contractor to undertake the service was implicit in Exposure Draft proposals. However it was certainly not explicit in the proposals, and is likely to require some entities to change their practices. Therefore, if the Board proposed to specify the relevant cash flows in this way, it would have to consider exposing the change for comment first. The consultation could be limited to this change only—it would not necessarily require re-exposure of the whole standard.

Draft text

24. A (separately posted) appendix to this paper illustrates how the guidance might look if it were based on the Exposure Draft proposals, supplemented with the additional guidance discussed in paragraphs 20 and 21.

25. It is a rough first sketch. If the Board decided to proceed on the basis suggested, the staff would spend more time on the drafting. And the Board would have an opportunity to discuss the drafting at a future meeting.

Staff recommendations and questions for the Board

Recommendation and question 1
On the basis of the arguments set out in this paper, the staff think that: - the Board should finalise the revisions to IAS 37 as quickly as possible. - it is unlikely that the Board will resolve quickly all the measurement matters that have been raised for discussion. - the Board could achieve significant improvements to the existing IAS 37 measurement guidance without resolving these matters. The staff therefore recommend that the Board finalises the guidance on measurement without trying to resolve the unresolved matters raised for discussion at previous meetings. Do you agree?

Recommendation and question 2
If the Board agrees with recommendation 1, the guidance will be based on that proposed in the Exposure Draft, supplemented with further guidance that the Board decided to add at previous meetings – as detailed in paragraph 20. For the reasons given in paragraph 21, the staff further recommend that the guidance also specifies that if an entity uses an expected cash flow approach to estimate a service obligation, such as an asset retirement obligation, the relevant cash flows are the amounts the entity would rationally pay a contractor to undertake the service. Do you agree?