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

Paper overview

1. This paper considers:

   (a) whether the Board should try to specify in more detail the measurement objective underpinning the proposed measurement guidance for IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*; and if so

   (b) what to specify as the measurement objective.

2. One reason for specifying the measurement objective in more detail would be to facilitate the use of the IAS 37 measurement model for other types of liabilities, such as those arising from insurance contracts.

3. This paper sets out two possible interpretations of the measurement objective. It considers whether the amount the entity 'would rationally pay to be relieved of the present obligation' is:

   (a) the minimum amount that the entity would *have* to pay, ie the amount that the counterparty would demand to cancel the obligation or a third party would demand to assume the obligation (paragraphs 13-17); or

   (b) the maximum amount that the entity would be *willing* to pay, ie lower of the amount described in (a) and the value to the entity of not having to fulfil the obligation (paragraphs 18-23).

4. The staff recommend (paragraphs 24-27) that:

   (a) the Board should specify the measurement objective in more detail,

   (b) it should interpret the objective as set out in paragraph 3(b).

   (c) the objective could be explained using wording like:

   > The amount an entity would rationally pay to be relieved of the present obligation is the lower of:
   >
   > (a) the value to the entity of not having to fulfil the obligation; and
   >
   > (b) the amount that the entity would have to pay to cancel the obligation or transfer it to a third party.
   >
   > If there is no evidence that the entity could cancel the obligation or transfer it to a third party, the entity measures the obligation at the value of not having to fulfil it. Guidance on measuring this amount is set out in Appendix [X].

Background

5. On the basis of guidance in paragraph 37 in the existing IAS 37, the Board has tentatively decided that:

> An entity shall measure a 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 it or transfer it to a third party.[1]

6. In April 2009, the Board decided not to specify exactly what amount an entity 'would rationally pay' to be relieved of an obligation. This was because:

    (a) there were (broadly) two different views among Board members about what this amount would be; and

    (b) the proposed measurement guidance for IAS 37 is consistent with both views, so there appeared to be no need to continue to debate the issue.

7. However, there are now reasons why the Board might wish to reconsider this decision:

    (a) at its meeting in June, the Board decided to consider the IAS 37 measurement model as a candidate for measuring insurance liabilities. As some Board members pointed out, it would be easier to understand the consequences of the IAS 37 model for insurance contracts if the model were more fully developed,

    (b) the same arguments will apply in future if the Board wishes to use the IAS 37 measurement model for other liabilities, and

[1] IASB meeting, April 2009, Agenda paper 8A, Appendix, Paragraph 29

(c) it might now be easier to achieve more consensus among Board members than it was in the past. Some Board members who had in the past rejected a model based on fulfilment notion did so in part because that model appeared to be cost-based and lack market discipline. However, in April this year, the Board tentatively decided to specify in IAS 37 that for obligations that are fulfilled by providing a service:

> … the relevant cash flows are the amounts that the entity would rationally pay a contractor to undertake the service on its behalf. In the absence of an efficient market for those services, the entity could estimate the amount it would rationally pay a contractor by estimating the amount it would itself charge another party to carry out the service. The latter amount would include the entity's estimates of the costs it expects to incur in fulfilling the obligation and the compensation it requires for providing the service inherent in the obligation.[2]

Such guidance would ensure that the measurement is not purely cost-based and incorporates a degree of market discipline.

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[2] IASB *Update*, April 2009

Possible ways of interpreting ‘would rationally pay’

8. The staff have identified four boundaries for the amounts at which liabilities might be exchanged or cancelled:

	A Exit amounts		B Entry amounts
Entity perspective	❶ The value to the entity of not having to fulfil the liability.		❸ The minimum amount the entity would demand to take on the liability.
		Fair value	
Market / counterparty perspective	❷ The minimum amount a market participant would demand to take on the liability or the counterparty would demand to cancel it.		❹ The maximum amount a market participant or the counterparty would pay the entity to take on the liability.

9. The staff think that:

   (a) in some circumstances, some of these boundary amounts might be the same as each other. However, because this possibility is not relevant to the matters considered in this paper, the staff have not explored it further.

   (b) fair value must lie somewhere within these boundaries.

   (c) entities will lay off liabilities in practice only if ❶ > ❷. Similarly, entities will take on liabilities in practice only if ❸ < ❹. For many liabilities within the scope of IAS 37, the converse could be true, which would explain why transfers do not occur in practice.

Possible amounts that the entity 'would rationally pay'

10. In IAS 37, the measurement objective is an *exit*, not an entry, amount, ie the amount that the entity would rationally *pay* to be relieved of the liability. So it could be argued that:

    (a) the relevant boundaries are those described in column **A**.

    (b) the amounts described in column **B** are relevant only as possible inputs for estimating the amounts in column **A**:

    > For example, the amount that an entity might be willing to pay to be relieved of risk might be most easily estimated by considering how much it would demand to assume the same risk.

11. Even having narrowed the possibilities to those in column **A,** the amount that the entity 'would rationally pay' to be relieved of the liability could be regarded as two different amounts:

    (a) *the minimum amount the entity would have to pay*. The entity would have to pay ❷ to be relieved of the liability. Only market assumptions would be relevant to this measure. (However, entity-specific assumptions might be the only evidence available of market assumptions.)

    (b) *the maximum amount the entity would rationally be willing to pay*. An entity would rationally be willing to pay no more than the lower of ❶ and ❷. (If it had to pay more than ❶ to transfer an obligation, it would instead choose to keep the obligation and fulfil it itself.) Thus, entity-specific assumptions are relevant to this measure.

12. The two different interpretations, and their consequences, are discussed further below.

The minimum amount the entity would have to pay

13. The first interpretation put forward in paragraph 11 is that, to be relieved of an obligation, the entity would rationally pay the minimum amount that it would *have* to pay, ie the lower of:

    (a) the amount a third party would demand to assume the obligation; or

    (b) the amount that the counterparty would demand to cancel the obligation, if cancellation is possible.

14. There is typically no market for liabilities within the scope of IAS 37. Therefore, an entity would have to estimate the amount that a third party would demand to assume the obligation. The entity could estimate this amount using an expected cash flow approach that takes into account the entity's estimates of:

    (a) the cash outflows that a market participant would expect to incur

    (b) the compensation that a market participant would require for providing any services inherent in the obligation

    (c) the compensation that a market participant would require for assuming the risk inherent in the obligation, and

    (d) the market assessment of the time value of money.

15. Therefore, the entity would use market data where available to arrive at its estimates. For example, suppose an entity expects to fulfil an obligation by undertaking a service (such as environmental decontamination) at a future date and there are contractors who perform that service. The entity could estimate the sum of (a) and (b) by estimating of the amounts that contractors would charge at a future date to perform the service.

16. However, such market data might not always be available. In the absence of evidence to the contrary, the entity would have to estimate the market assumptions on the basis of its own assumptions about the future cash flows etc. It could, for example, estimate the sum of (a) and (b) by estimating what it would charge another party to perform the service inherent in an obligation.

17. Therefore, this interpretation of the IAS 37 measurement objective appears to be consistent with the guidance on service obligations that the Board tentatively approved at its meeting in April.

The maximum amount the entity would be willing to pay

18. The second interpretation put forward in paragraph 11 is that the amount the entity 'would rationally pay' is the maximum amount that it would rationally be *willing* to pay. This amount is the lowest of:

    (a) the value to the entity of not having to fulfil the liability (an entity-specific measure);

    (b) the price that the market would demand to assume the liability; and

    (c) the price that the counterparty would demand to cancel the liability, if cancellation is possible.

19. In theory, all three amounts need to be measured to identify the lowest one. However, in practice, the exercise might not be as onerous as it appears. It could be argued that:

(a) typically, there is no market for liabilities within the scope of IAS 37. Therefore, it is unlikely that there will be evidence to support any estimate of a market transfer price that is lower than the entity's own estimates based on fulfilment.

(b) similarly, an entity cannot usually cancel an obligation within the scope of IAS 37 for less than the burden of fulfilling it. Otherwise, it would rationally already have done so, or at least have started the process of doing so. So an entity would consider a cancellation price only if there is objective evidence of cancellation being a realistic possibility in practice.

20. Thus, in most situations, the only amount that an entity would have to estimate is the value of not having to fulfil the obligation. Therefore, the measurement objective could be explained in something like the following terms:

> The amount an entity would rationally pay to be relieved of the present obligation is the lower of:
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> (a) the value to the entity of not having to fulfil the obligation; and
>
> (b) the amount that the entity would have to pay to cancel the obligation or transfer it to a third party.
>
> If there is no evidence that the entity could cancel the obligation or transfer it to a third party, the entity measures the obligation at the value of not having to fulfil it. Guidance on measuring this amount is set out in Appendix [X][3].

[3] This appendix will set out guidance on using expected cash flow approaches. The latest draft discussed by the Board was in the Appendix to paper 8A for the April 2009 Board meeting.

21. The value of an entity of not having to fulfil an obligation is essentially an entity-specific measure. It is a measure of 'value', not necessarily of 'cost'. It could be argued that it would be estimated taking into account:

    (a) the value to the entity of not having to make the payments or undertake the services necessary to fulfil the obligation;

    (b) the value to the entity of not having to bear the risk in the expected cash outflows; and

    (c) the time value of money.

22. If the entity expects to fulfil the obligation by undertaking a service (such as environmental decontamination) at a future date, the entity could estimate (a) by estimating the amount that it would be willing to pay a contractor at the future date to undertake the service. If an efficient market exists for such services, the amount could be the price that a subcontractor would charge. If there is not an efficient market, the amount could be the price that the entity estimates it would itself charge another party to undertake the service.

23. Thus this second, more entity-specific, interpretation of the IAS 37 measurement objective also appears to be consistent with the guidance on service obligations that the Board tentatively approved in April.

Staff conclusions and recommendations

24. On the basis of the analysis above, the staff have concluded that each of the interpretations discussed in this paper could underpin the (limited) guidance that the Board has tentatively decided to include in IAS 37.

25. The staff recommend that the Board specifies one or other of the interpretations in the standard:

    (a) a clearer understanding of the measurement objective might help preparers judge how to apply IAS 37 in situations not specifically covered by application guidance.

    (b) it would also help the Board identify how the IAS 37 measurement model would apply to insurance liabilities, or any other liabilities to which the Board considers applying the model in future.

26. The staff recommend the second of the two interpretations, ie the 'lower of' interpretation discussed in paragraphs 18-23. The staff think that:

    (a) this interpretation overcomes one of the main objections to the proposed measurement objective, ie that market-based measures are not relevant for liabilities that typically entities have to fulfil themselves; and

    (b) this interpretation, although based on entity-specific assumptions, imposes a degree of market discipline on the measurement of the liability. The entity has to estimate what it would pay to or charge another entity for services and risks, not just add up the (arbitrarily defined) costs of fulfilling the obligation.

(c) the ‘lower of’ notion mirrors the ‘higher of’ notion for assets in IAS 36 *Impairment of Assets*. IAS 36 requires impaired assets to be valued at their recoverable amount, ie the higher of value in use and fair value less costs to sell. The mirror image for liabilities is to measure them at the lower of the burden of fulfilling the obligation and the transfer/cancellation price.

27. The staff expect that neither interpretation is likely to completely satisfy Board members and others who think that the entity should be measuring liabilities at the expected *cost* of fulfilling the obligation, rather than the *value* of not having to fulfil it. However, the staff think that to satisfy those people, the Board would have to change the measurement objective itself. The Board has on a number of previous occasions decided not to do this.

Questions for the Board

1	Whether to specify the measurement objective in more detail
	Do you agree with the staff recommendation (paragraph 25) that the Board should specify the measurement objective in more detail in IAS 37?

2	How to interpret the measurement objective
	Do you agree with the staff recommendation (paragraph 26) that the measurement objective should be the lower of: - the value to the entity of not having to fulfil the obligation; and - the amount that the entity would have to pay to cancel the present obligation or transfer it to a third party?

3	Emphasis on fulfilment
	In paragraphs 19-20, the staff suggest that for many liabilities within the scope of IAS 37, the entity would not be able to transfer or cancel the liability. To avoid requiring entities to seek a market/cancellation price in such situations, the staff suggest adding the following guidance: "If there is no evidence that the entity could cancel the obligation or transfer it to a third party, the entity measures the obligation at the value of not having to fulfil it." Do you agree with this guidance?