Project **Liabilities—amendments to IAS 37**

Topic **Proposals to clarify measurement requirements**

Introduction

1. The IASB proposes to add more guidance to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* to clarify the measurement requirements. It plans to expose this guidance for comment before finalising the new standard.

2. At the meeting, we'd like to hear your views on the proposals. This paper explains them.

Background

3. In 2005, the IASB published an exposure draft of proposed amendments to IAS 37. Picking up existing wording in IAS 37, it proposed that entities should measure liabilities at the amount they would 'rationally pay to settle the present obligation or to transfer it to a third party on the balance sheet date'.

4. Respondents commented that they found the requirements unclear. Did settle mean 'cancel' or 'fulfil'? What if the entity cannot fulfil the obligation at the balance sheet date? And could the amount to settle be different from the amount to transfer the obligation? If so, which amount should the entity use?

5. In response, the IASB decided to develop more guidance on the meaning of the existing requirements.

Proposed clarifications

6. The IASB has concluded that the intention in IAS 37 is that a liability should be measured at the amount the entity would rationally pay on the reporting date *to be relieved of* that liability.

7. The IASB has tentatively decided that the amount an entity would pay to be relieved of a liability depends on:

   (a) the value the entity would gain (ie how much better off it would be) if it did not have to fulfil the liability;

   (b) the payment the counterparty would demand to cancel the liability; and

   (c) the payment a third party would demand to assume the liability.

   The IASB has concluded that the entity would *rationally* pay the lowest of these three amounts to be relieved of the liability.

8. Many liabilities within the scope of IAS 37 cannot be cancelled or transferred to third parties. Hence, the IASB proposes that, unless there is evidence that the entity could cancel or transfer a liability for a lower amount, it should measure the liability at the value it would gain (ie how much better off it would be) if it did not have to fulfil the obligation.

9. The IASB proposes that entities should estimate this amount taking into account:

   (a) the outflows of resources expected to be required to fulfil the obligation,

      taking into account all the possible outcomes, weighted according to their associated probabilities.

   (b) the time value of money,

      ie, the outflows would be discounted to their present values.

   (c) any additional amount the entity would rationally pay to be relieved of a liability for which the amount or timing of the outflows is uncertain.

      A risk adjustment would be added if required.

10. Finally, the IASB proposes to give guidance on how entities should measure the outflows of resources described in paragraph 9(a). It proposes that:

   (a) if the obligation is to pay cash to the counterparty (for example, as a result of a legal claim), the outflows would be the cash payments;

   (b) if the obligation is to undertake a service, such as decommission an asset, the outflows would be measured at the value of the service. The way of estimating the value of the service would depend on the circumstances:

      (i) if there is a market for the service, the outflows would be measured at the amount a contractor would charge the entity to undertake the service on its behalf; or

      (ii) if there is not a market for the service, the entity would estimate the amount it would itself charge to undertake the service for another party. It would take into account both its expected costs and the margin it would require for providing the service.

11. Thus, applying the IASB's proposals, entities would typically estimate their liabilities by discounting the expected future outflows to their present value and adding a risk adjustment if necessary—much as they do in practice at present. The only differences would be that:

    (a) the standard would be clearer that the estimates should take into account all possible outcomes, not just the most likely one;

    (b) the standard would be clearer that, if there is evidence that the entity could cancel or transfer the liability for a lower amount, it should measure the liability at the lower amount; and

    (c) if an obligation will be fulfilled by undertaking a service, such as decommissioning an asset, at a future date, the service outflows would be measured on the basis of their value not their cost—typically the amount that the entity estimates a contractor would charge on the future date to undertake the service.

Reasons for proposals on service outflows

12. The IASB debated for some time whether service outflows should be measured at their cost or value (with value being estimated using contractor prices) Most IASB members favoured using contractor prices, on the grounds that:

    (a) *this approach is consistent with the measurement objective.* The objective is to estimate the amount the entity would pay today to be relieved of the obligation. If an entity has an obligation to undertake a service in future, the amount that it would rationally pay to avoid that obligation would reflect the value—not just the cost—of the resources it will have to sacrifice to fulfil it.

(b) *the approach ensures that value creation is attributed to all the entity's activities.* All of the activities that an entity undertakes are necessary for it to generate revenue and create value for the business. For example, to produce oil, an entity must construct, operate and decommission an oil rig. The entity should attribute the value it creates to all of these activities – not just the activities that have been completed when it delivers oil to customers. Remaining obligations should not be measured at cost.

(c) *using contractor prices enhances consistency and reliability of measurements*. A requirement to estimate the amount that the entity would pay a contractor to undertake the service would improve comparability by imposing a degree of market discipline on the measurements. At present, practices diverge—entities include different costs in their estimates of future cash flows, with some accounting for only marginal costs. The IASB could address these inconsistencies by providing rules on which costs (direct costs, overheads, finance costs?) entities should include. But without an underlying measurement objective, these rules would be essentially arbitrary and could lead to calls for further interpretation. In contrast, if the relevant cash flows are based on the price a contractor would charge to undertake the service, there is a clear measurement objective (ie a price) and so no need for arbitrary rules. The prices are also observable in the market so estimates are readily verifiable.

13. We have been told that some mining (and possibly other) companies already measure their decommissioning and environmental liabilities in accordance with the proposals, ie their estimates of future cash flows are based on the amounts they estimate they would have to pay contractors to undertake the work on their behalf.

Question for ARG and GPF members
What are your thoughts on these proposals?