IASB Meeting	Agenda reference	7
Staff Paper	Date	September 2010

Project **Liabilities—IFRS to replace IAS 37**

Topic **Project direction**

Meeting objective

1. The purpose of the meeting is to decide how to proceed with the project to replace IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

2. The decision is to be taken in the light of responses to the exposure draft ED/2010/01 *Measurement of Liabilities in IAS 37* ('the 2005 exposure draft').

Papers for the meeting

3. In this paper, the staff:

   (a) briefly summarise the proposals in the exposure draft (paragraphs 5-10)

   (b) highlight key messages in the responses (paragraphs 11-20)

   (c) analyse the comments (paragraphs 22-45)

   (d) identify three ways in which the Board could proceed (paragraph 46).

4. Two appendices provide supporting information:

   (a) Appendix A—comment letter summary

   (b) Appendix B—a reminder of what's wrong with IAS 37 and the range of improvements that a new IFRS could deliver.

Exposure draft proposals

5. The 2010 exposure draft re-exposed for further comment one section of the proposed IFRS to replace IAS 37. The Board had exposed the original proposals for comment in 2005. The revised proposals do not significantly change the original proposals. Rather, the revised proposals explain in more detail:

   (a) the measurement objective; and

   (b) how entities should implement the measurement objective.

Scope of the new IFRS

6. The new IFRS, like IAS 37 and the 2005 exposure draft, would apply to all liabilities not within the scope of other IFRSs. Typically these are non-contractual liabilities. They include:

   (a) statutory asset decommissioning and environmental obligations;

   (b) liabilities to pay compensation or fines for acts of wrong-doing ('litigation liabilities');

   (c) statutory guarantees, ie those that arise from laws, rather than contracts; and

   (d) onerous contracts, other than those within the scope of other IFRSs.

Measurement objective

7. Using words similar to those in the 2005 exposure draft—and as an interpretation of the existing measurement requirements in IAS 37—the 2010 exposure draft proposes that an entity should 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'.

8. *In addition*, the 2010 exposure draft expands this requirement to clarify that the amount that an entity 'would rationally pay' is the *lowest* of:

   (a) the present value of the resources required to fulfil the obligation;

   (b) the amount that the entity would have to pay to cancel the obligation; and

   (c) the amount that the entity would have to pay to transfer the obligation to a third party.

Implementation guidance

9. The 2010 exposure draft specifies how an entity would measure the present value of the resources required to fulfil an obligation. Like the 2005 exposure draft it proposes that, if the outcome of a liability is uncertain, the entity should:

   (a) estimate the 'expected value' of the future outflows, ie take into account all possible outcomes, weighted according to their estimated probabilities; and

   (b) add a risk adjustment.

10. *In addition*, the 2010 exposure draft proposes to specify that:

    (a) the relevant outflows for obligations to render services at a future date (such as obligations to decommission assets) are the amounts that the entity would rationally pay a contractor at the future date to render the service on the entity's behalf ('a contractor price').

    (b) the purpose of the risk adjustment is to measure the additional amount, if any, that the entity would rationally pay to be relieved of the risk that the actual outflows of resources might ultimately differ from those expected.

Key messages in responses

11. Appendix A summarises the main issues raised in the comment letters. The staff highlight below the key messages that we think will affect the Board's decision about how to proceed with this project.

Relevance of expected values

12. Many respondents—including in particular preparers, auditors, accountancy bodies and national standard setters—continue to think that financial statements provide investors and analysts with the most relevant information about liabilities if they recognise and measure the *individually most likely* future outflows. Accordingly:

(a) most of these respondents continue to oppose the 2005 proposal that entities should measure liabilities using expected values.

(b) some also disagree with the ‘lowest of’ notion in the measurement objective. They think that an entity should measure a liability using a cancellation or transfer price *only* if the entity expects to discharge its liability in that way.

(c) many also continue to express opposition to the 2005 proposals to delete the existing ‘probable outflows’ recognition criterion. This criterion in IAS 37 at present prevents recognition of some liabilities (such as guarantees) unless and until it becomes probable that the liability will result in an outflow of economic benefits.

(d) many criticise the Board’s due process. They think that the Board should have re-exposed the entire IFRS, not only the revised measurement requirements. Most of those respondents comment on other sections of the draft IFRS. The focus of their concerns is the removal of the ‘probable outflows’ recognition criterion.

13. However, the seven investor and analyst groups responding do not seem to share these views. They are generally supportive of the measurement objective and hierarchy and only two question the relevance of expected value measurements. Further, none expresses opposition to the removal of the ‘probable outflows’ criterion (although one is concerned about the conflict with the *Framework*, and thinks that the new *Framework* should be completed first).

Reliability and costs of measuring expected values

14. Many respondents of all types continue to express concerns that entities cannot reliably measure (and auditors cannot verify) the expected values of some liabilities within the scope of IAS 37. They argue in particular that legal advisers cannot make reliable estimates of the probabilities of the various outcomes for some litigation liabilities. Although the draft IFRS does not require entities to recognise liabilities that cannot be measured reliably, it describes such liabilities as 'extremely rare'.[1] This constraint would prevent entities from applying the exception as often as respondents think it is needed.

Judgement about whether a liability exists

15. The draft IFRS would require an entity defending a lawsuit to consider all available evidence and reach a judgement about whether it has a liability. Some respondents remain concerned about the difficulties of applying this requirement. Two particular concerns are that:

    (a) the requirement cannot be applied without a probability threshold. IAS 37 requires entities to judge whether it is 'more likely than not' that a liability exists; and

    (b) there is insufficient implementation guidance. The guidance in the staff paper *Recognising Liabilities arising from Lawsuits* is helpful, but it is not authoritative and might not have Board support.

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[1] IAS 37 also includes such a statement, to prevent excessive use of the 'reliable measurement' exception.

US convergence concerns

16. Respondents also raise concerns that the proposals would not be workable in the US. The proposed recognition threshold would be lower than that applied in US GAAP at present, and expected value measurements would require more information about the range of possible outcomes. In the US legal environment:

    (a) both the amounts recognised and the legal opinions needed to support the estimates of expected values could be 'discoverable' by adversaries, thus prejudicing the outcome of the case; and

    (b) defendants could be exposed to class action lawsuits by their shareholders if the liability measurement fluctuates from one period to the next and the eventual payment differs from the amount they had previously recognised as a liability.

Use of contractor prices

17. There is very little support for the proposal to require entities to use contractor prices to measure future outflows. The overwhelming majority of respondents – including all except one of the user groups – think that the relevant outflows are the expected costs (which will be contractor prices only if the entity intends to outsource the service to contractors).

Risk adjustment

18. Opinion is divided on the proposal to require a risk adjustment. Some respondents—including two user groups—are supportive of the proposal. Others—including four user groups—are opposed, or at least have concerns. The main concern is that measurements of risk adjustments for liabilities within the scope of IAS 37 are unreliable and open to manipulation. Many respondents—including both supporters and opponents of the risk adjustment—

ask for more guidance on how to measure it. (It is unclear from responses whether and how entities measure the risk adjustment required by IAS 37 at present.)

Existing diversity in practice

19. Respondents highlight several areas in which they think that a lack of guidance in IAS 37 is causing diversity in practice at present. Possibly the most serious matter is a difference in views about whether it is acceptable to include the effect of non-performance risk in discount rates. Even small increases in discount rates can lead to material reductions the reported amounts of long-term decommissioning obligations.

Comments on other sections of the working draft IFRS

20. Respondents have not restricted their responses to comments on the measurement proposals in the exposure draft. Many have also commented on other sections of the working draft IFRS. Most of the comments relate to the proposed changes in the recognition criteria, as discussed above. They do not highlight any major widespread concerns about other sections of the draft IFRS.

21. However, respondents make requests for more guidance, for example on:

(a) the requirement to disclose information about the uncertainties surrounding liability measurements;

(b) recognition of ‘contingent assets’, ie the plaintiff’s right to compensation in a lawsuit; and

(c) identifying onerous contracts.

Staff analysis

Preliminary thoughts

22. The Board started this project in 2002. It has discussed the main conceptual and practical issues on many occasions. The staff are mindful that the Board now needs to wrap up this project—one way or another—on a timely basis. Thus, in considering how to proceed, we have assumed that the Board will not wish to spend significant time exploring alternative models. In other words, if the Board cannot resolve issues arising from specific proposals in a timely manner, it should consider withdrawing these proposals.

23. The staff also think that a decision about how to proceed with this project hinges on the Board's response to the comments about expected value measurements. This is because:

    (a) the proposal to mandate expected value measurements for all liabilities within the scope of IAS 37 is one of the most controversial aspects of the project;

    (b) the proposed measurement objective (the amount that the entity would rationally pay on the reporting date to be relieved of the obligation) implicitly requires an expected value approach. If the Board decides not to mandate an expected value approach, it would need to reconsider the measurement objective and thus all aspects of the proposed measurement requirements. If it does not want to embark on developing a new model at this stage, it would need to consider leaving the existing IAS 37 measurement requirements in place. In contrast, the Board might be able to amend other aspects of the proposed measurement requirements (such as the requirement for risk adjustments or for the use of contractor prices to measure service outflows) without compromising the overall measurement model.

(c) many respondents also raised continuing concerns about the proposal (exposed in 2005) to remove the 'probable outflows' recognition criterion. The Board's response to these comments will depend on its decisions regarding expected values. If the Board decides not to mandate expected value measurements, entities would continue to measure liabilities at their most likely outcome. The 'probable outflows' recognition criterion could be somewhat redundant in practice: if future outflows are not probable, the measurement of the liability (the most likely outcome) would be nil. However, if the Board decides to mandate expected values, removal of the probable outflow recognition criterion would remain an important aspect of the proposals—from a conceptual viewpoint, the criterion is incompatible with expected value measurements.

24. Because the staff think that the future direction of the project hinges on the Board's reaction to comments about expected values, this section focuses on these comments.

Analysis of comments on expected values

Relevance of expected values

25. As explained in paragraphs 3.3.7-3.3.10 of Appendix A, most preparers, auditors, accountancy bodies and national standard setters responding oppose expected value measurements for single obligations within the scope of IAS 37. The most frequently-cited argument is that, in the opinion of those respondents, expected values do not provide relevant information to investors and other capital providers, because they are not predictions of the *most likely* future outflows. In some cases, the expected value is not even one of the *possible* outflows.

26. The Board's counterargument (in paragraph BC14 of the exposure draft) is that investors use forecasts of future outflows to estimate the value of their claims to the entity's resources. The expected value of an obligation—*not* the most likely outcome—measures the impact of an obligation on the value of an investor's claim. It is therefore the most relevant measure. Information need not predict the *most likely* outcome to have predictive value.

27. The views of the investors and analysts responding (paragraph 3.3.2 of Appendix A) appear to support this view. Only two of the seven user groups responding express an overall preference for measurements based on most likely outcomes. Others are either strongly supportive of expected values, silent on the matter, or have reservations only about the reliability or costs of expected value measurements in some cases. They tend to request more information about the range of possible outcomes, but arguably have just as much need for this information whichever measure is recognised in the balance sheet.

28. When assessing the relevance of information, the views of users are paramount. In this case, they lend support to the Board's proposals.

Reliability of expected values

29. As detailed in paragraphs 3.3.11 to 3.3.14 of Appendix A, most respondents—including users, preparers, auditors and lawyers—have expressed concerns about entities' ability to measure reliably some litigation liabilities and some guarantees (those that are highly unlikely to be called upon).

30. Several lawyers and preparers have given detailed illustrations of the difficulties of measuring litigation liabilities, particularly at the early stages of a dispute, or in some jurisdictions, eg in the US, where pharmaceutical and other companies are exposed to 'mass tort' litigation. Arguably, in some of the situations described by respondents, the proposed measurement requirements would be no more difficult to apply than the existing IAS 37 requirements:

    (a) the available information would not support a conclusion that a litigation liability exists—so the entity would not need to recognise, or hence measure, a liability.

    (b) there is so much uncertainty about the outcomes that the entity would not be able to measure the most likely outcome either. (To measure the most likely outcome, entities must identify at least some of the possible outcomes and their relative probabilities.)

    (c) the probability of an outflow arising from a guarantee would be so low that the expected value would be immaterial, unless the potential outflow is huge.

31. Nevertheless, the range of problems identified by respondents indicates that, if the Board wishes to proceed with an expected value model, it should consider addressing the practical difficulties.

32. The Board could perhaps address these difficulties by:

    (a) relaxing its position that the situations in which entities cannot measure liabilities reliable are 'extremely rare'. The Board could perhaps provide guidance on the types of situation in which this reliable measurement may not be possible; and/or

(b) permitting simplified measurements in some situations. This possibility was put forward in E59, the IASC exposure draft that preceded IAS 37:

> 26 Where the obligation being measured does not involve a large population of items, there may be insufficient evidence of the various possible outcomes and their probabilities to permit an explicit calculation of expected values. In these situations other methods of estimation are used.
>
> 27. Where there is an equal chance that the outcome will be greater or less than the most likely outcome (i.e. the outcome with the highest probability), the most likely outcome is used. The most likely outcome is, however, not used if there are a number of other possible outcomes such that the balance of probability is that the actual outcome will be substantially higher or lower than the amount of the most likely outcome. For example, if an enterprise has to rectify a serious fault in a major plant that it has constructed for a customer, the most likely outcome may be for the repair to succeed at the first attempt at a cost of 1,000, but a provision for a larger amount is made if there is a significant chance that further attempts will be necessary. Where there is a continuous range of possible outcomes, and each point in that range is as likely as any other, the mid-point of the range is used.

Consistency with other projects

33. It is of note that several current projects are affected by liability measurement issues. The Board is proposing an expected value model for other liabilities—ie revenue, insurance contract. and lease liabilities—and consistency between IFRSs is desirable.

Staff notes on other matters raised in the comment letters

Contractor prices

34. As explained in section 3.4 of Appendix A, there is overwhelming opposition to the proposal to measure service outflows at contractor prices. The staff think it might be difficult to resolve the issues raised by the respondents in a timely manner. Therefore, whatever the merits of the proposal, it could be argued that the Board should withdraw it.

35. The Board could instead propose the approach in the alternative view, ie a requirement to measure the future expected *costs*. It could make this change without having to reconsider the measurement objective or other aspects of the measurement model. However, it would need to consider specifying the types of costs that entities include. Responses indicate that there is diversity in practice applying IAS 37 at present.

Judgement about whether a liability exists

36. The staff think that the Board could readily address concerns about the difficulties of judging whether a liability exists. Without needing to invest too much further time or resources on this matter, the Board could:

    (a) add a specific 'more likely than not' threshold to the assessment of whether a liability exists. The threshold exists in IAS 37 at present and the Board did not give clear reasons for excluding it from the proposals in the 2005 exposure draft; and

    (b) debate the staff paper *Recognising Liabilities Arising from Lawsuits* and incorporate the conclusions with which it agrees into the IFRS.

37. These steps would make it clearer that many situations in which measurement would be most difficult will not qualify for recognition anyway.

US concerns

38. The additional concerns raised by US lawyers and preparers and others with US interests arise primarily because defendants would need to recognise (and hence measure and disclosure information about) more liabilities than they recognise at present applying US GAAP.

39. The need to recognise more liabilities is not a consequence of the proposed *changes* to IAS 37. The recognition threshold in IAS 37 is already different from that in US GAAP[2], and the difference would not be significantly greater applying the new IFRS. Therefore, the Board needs to consider US convergence concerns irrespective of the other decisions it reaches about this project.

40. The proposed changes to IAS 37 ought to alleviate some US convergence issues. For example, because expected value measurements are not predictions of the outcome of the case, defendants might be less vulnerable to shareholder class action lawsuits than they would be applying a model that requires them to predict the most likely outcome.

41. Some of the other steps that the Board could take if it proceeds with this project might also help. Removing the 'extremely rare' constraint from the reliable measurement recognition criterion would reduce the number of liabilities that entities would need to recognise. Adding a specific 'more likely than not' threshold to the judgement about whether a liability exists might help avoid the impression that recognising a liability is an admission of guilt—US lawyers and preparers are among those who particularly request this change.

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[2] Like IAS 37, FASB ASC Subtopic 450-20 requires entities to recognise a loss contingency if it is probable that a liability has been incurred. However, 'probable' is not defined to mean 'more likely than not'. The American Bar Association's *Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information* advises that an adverse outcome is probable if the defendant's prospects for the success are 'judged to be slight'. If the defendant's prospects are anything better than 'slight', the defendant does not recognise a liability.

Diversity in practice

42. Respondents have identified aspects of IAS 37 that are leading to diversity in practice at present. If the Board decides not to continue its project to replace IAS 37, it or the IFRS Interpretations Committee would need to consider the need for interpretative guidance in the areas identified by respondents.

Other matters raised on comment letters

43. As reported in paragraph 21, respondents ask the Board to consider adding more guidance on a number of other matters. The staff think that the Board could reach decisions on each of these requests relatively easily. But some staff and Board time would be needed to address each one.

Due process

44. The comments on due process reflect similar concerns raised in a letter sent by a group of interested parties to the Trustees of the IFRS Foundation earlier this year. The Trustees' Due Process Oversight Committee has asked the IASB to take the concerns into account in considering the comments on the exposure draft and to report back to the Trustees on its conclusions.

45. The need for, and nature of, further due process on this project will depend on whether and how the Board decides to progress its proposals. However, the Board will need to keep due process requirements in mind when considering the timescales required for completion of the project.

Possible options for the Board

46. Taking the matters raised in the staff analysis into account, the staff have identified three ways in which the Board could proceed with this project:

Option	Possible reasons for supporting
1 Take project off agenda • Abandon current project to replace IAS 37 with a new IFRS. • Consider asking IFRS Interpretations Committee to address matters causing diversity in practice and on which the committee might reach a timely consensus, eg: - discount rates (non-performance risk); - need to include indirect costs. • Consider the need for further action to address US concerns about the difficulties of applying IAS 37 to US litigation. • Use ideas developed in this project to inform future debates on elements and recognition in the conceptual framework project.	• You think the Board should not mandate an expected value model in IAS 37 at present. • You think the other weaknesses in IAS 37 (see Appendix B) **are not** sufficiently serious to merit a new IFRS. • You think the Board should complete the conceptual framework project first.
2 Proceed to new IFRS without revising IAS 37 measurement requirements • Revise requirements and guidance for identifying and recognising liabilities, reimbursement rights and contingent assets as proposed. • Consider addressing specific measurement matters causing diversity in practice and which the Board could readily resolve, eg: - discount rates (non-performance risk); - inclusion of indirect costs. • But otherwise keep without revision the measurement requirements in IAS 37, thus allowing entities to continue interpreting 'best estimate' to mean 'most likely outcome'. • Consider the need for further action to address US concerns about the difficulties of applying IAS 37 to US litigation.	• You think the Board should not mandate an expected value model in IAS 37 at present. • You think other weaknesses in IAS 37 **are** sufficiently serious—and the proposals for addressing them are sufficiently well supported—to merit proceeding with the other revisions now.

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3 Continue to develop new IFRS with expected value model but address reliability/cost concerns

- Re-affirm proposed measurement objective and expected value measurement model.
- Reconsider aspects of the measurement requirements with a view to addressing reliability and cost-benefit concerns. In particular:
  - consider simplified or alternative measurement approaches for limited situations in which entities cannot estimate expected values reliably, or relax ‘extremely rare’ constraint in the reliable measurement recognition criterion.
  - consider keeping the explicit ‘more likely than not’ threshold in IAS 37 for the judgement about whether a liability exists
  - debate the guidance in the staff paper *Recognising Liabilities arising in Lawsuits* to confirm that Board members agree with it. Incorporate agreed guidance into the proposed IFRS.
  - reconsider the proposal to require a risk adjustment and/or the need for further guidance on how to measure the risk adjustment.
- withdraw the proposal to require entities to measure future service outflows by reference to contractor prices. Instead require entities to estimate future costs and specify whether entities should include indirect costs.
- consider (without prolonged debate) requests for additional guidance, eg on disclosure requirements, contingent assets and onerous contracts.
- consider whether further action is needed to address concerns about the difficulties and risks of applying the proposals to US litigation. (Some of the changes to address reliability and cost-benefit concerns might also help address US concerns.)

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- You think that the responses from users—and the benefits of consistency with other liability IFRSs—justify the proposed measurement objective and expected value model.
- But you accept respondents’ arguments that entities cannot always estimate reliably—and at reasonable cost—the expected values of some liabilities within the scope of IAS 37.
- You agree that the Board needs to wrap up this project on a timely basis. Hence, whatever your views on measuring future service outflows by reference to contractor prices, you accept that the Board should withdraw this proposal at present.
- You think the Board could reach decisions on other matters on a timely basis.

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Question for the Board

47. The staff have identified three ways in which the Board could proceed with this project:

- OPTION 1: Take the project off the Board's agenda.
- OPTION 2: Issue a new IFRS without substantially altering the IAS 37 measurement requirements.
- OPTION 3: Continue to develop an IFRS with an expected value measurement model. But withdraw the requirement for entities to measure service outflows at contractor prices and consider four other changes to address reliability and cost-benefit concerns.

Question for the Board
In which of these, or other, ways do you think that the Board should proceed with this project?