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Exposure Draft ED/2010/1

Measurement of Liabilities in IAS 37

Proposed amendments to IAS 37

Comments to be received by 12 April 2010



International
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Exposure Draft

**MEASUREMENT OF LIABILITIES
IN IAS 37
(Limited re-exposure
of proposed amendment
to IAS 37)**

Comments to be received by 12 April 2010

ED/2010/1

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(Limited re-exposure of proposed amendment to IAS 37)

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Introduction and invitation to comment

Background

The International Accounting Standards Board is undertaking a project to improve IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. The main aims of the project are:

- to align the criteria in IAS 37 for recognising a liability with those in other IFRSs. At present, IAS 37 requires an obligation to be recognised as a liability only if it is probable (ie more likely than not) that the obligation will result in an outflow of cash or other resources from the entity. Other standards, such as IFRS 3 *Business Combinations* and IAS 39 *Financial Instruments: Recognition and Measurement*, do not apply this 'probability of outflows' criterion for recognising liabilities.
- to eliminate some differences between IAS 37 and US generally accepted accounting principles (GAAP)—in particular, differences in the time at which entities recognise costs of restructuring their businesses.
- to clarify the measurement of liabilities in IAS 37. At present the measurement requirements in IAS 37 are vague. As a result, entities use different measures, making it difficult for capital providers to compare their financial statements.

Two aspects of the IAS 37 measurement requirements are particularly vague:

- the standard requires an entity to measure a liability at the 'best estimate' of the expenditure required to settle the present obligation. It is not clear to all what the term 'best estimate' means. In practice, the term is interpreted as meaning the most likely outcome, the weighted average of all possible outcomes or even the minimum or maximum amount in the range of possible outcomes.
- IAS 37 does not specify the costs that entities should include in the measurement of a liability. In practice, some entities include only incremental costs. Some include all direct costs. Some add indirect costs and overheads. Some use the prices they would pay contractors to fulfil the obligation on their behalf.

In 2005 the Board published an exposure draft of proposed amendments to IAS 37. Regarding measurement, the exposure draft proposed to remove the term 'best estimate' and instead focus on other guidance in IAS 37, which states that the best estimate of a liability is the amount that an entity would rationally pay to settle

the liability at the end of the reporting period or to transfer it to a third party at that time. The exposure draft proposed that this amount would be measured taking into account all possible outcomes—not only the minimum, maximum or most likely amounts.

Reasons for publishing this exposure draft

Some respondents to the 2005 exposure draft thought that the proposed requirements remained unclear. What did 'settle' mean—did it mean cancel or fulfil? What if the amount to settle the obligation was different from the amount to transfer it—at which of the two amounts should the liability be measured? And what if—as is often the case—the entity could not transfer a liability to a third party? Was the entity supposed to measure the liability at an amount that it could never pay in practice?

In response to those concerns, the Board now proposes to add guidance specifying more precisely what entities should be aiming to measure, and how they should achieve that aim. This exposure draft invites comments on the proposed new guidance.

The main features of the proposed measurement requirements

Measurement objective

- The overall measurement objective would be to measure the amount that the entity would rationally pay at the end of the reporting period to be relieved of the obligation.
- Normally this amount would be the present value of the resources required to fulfil the obligation. Estimates of this amount would take into account the expected outflows of resources, the time value of money and the risk that the actual outflows might ultimately differ from those expected.
- In some circumstances, there might be evidence that the entity could cancel the liability or transfer it to a third party for a lower amount. In such circumstances, the entity would measure the liability at this lower amount. The Board does not expect such situations to arise often. Entities are often unable to cancel or transfer particular liabilities within the scope of IAS 37. Also, if an entity could cancel or transfer a liability for an amount lower than that required to fulfil the liability, it might have already done so.

Measurement of the expected outflows

- If the outflows of resources required to fulfil the obligation are uncertain, the entity would estimate their expected value, ie the probability-weighted average of the outflows for the range of possible outcomes. The expected value is unlikely to be the amount that an entity ultimately pays to fulfil the liability. But the Board believes it is a relevant measure for capital providers, who would consider all possible outcomes and their relative probabilities when assessing the effect of a liability on the value of their claims to the entity's resources.
- The expected value calculations need not be complex. A limited number of discrete outcomes and probabilities can often provide a reasonable estimate of the distribution of possible outcomes.
- If an obligation is to pay cash to a counterparty (for example to settle a legal dispute), the future outflows used to measure the obligation would be the expected cash payments plus any associated costs, such as legal fees.
- If, in contrast, an obligation is to undertake a service (for example to decommission plant or equipment) at a future date, the outflows would be the amounts that the entity would rationally pay a contractor at the future date to undertake the service on its behalf. Often there are contractors in the market who provide such services. Therefore estimates of contractor prices can be more objective measures of future outflows than estimates of the entity's own future costs. In addition, by specifying an objective (contractor prices) the standard would not need detailed and arbitrary rules on which costs should be included, eg whether, and to what extent, the entity should include indirect costs and an allocation of overheads.
- A limited exception to the requirement in the preceding paragraph would apply to onerous contracts arising from transactions within the scope of IAS 18 *Revenue* or IFRS 4 *Insurance Contracts*. An entity would measure the future outflows arising from such contracts by reference to the costs it expects to incur to fulfil its contractual obligations, rather than the amounts it would pay a contractor to fulfil them on its behalf. The purpose of this exception would be to postpone any change in practice for measuring onerous sales and insurance contracts, pending completion of the Board's projects on revenue recognition and insurance contracts.

Other changes to the 2005 exposure draft

The Board has revised other aspects of the proposals in the 2005 exposure draft. Most of the revisions respond to feedback on the 2005 proposals, or are relatively minor. A full list of the proposed revisions is in a decision summary linked to the *Liabilities—Amendments to IAS 37* project page of the IASB website.

The Board is also preparing a working draft of the proposed new standard and aims to post a copy on its website in February 2010. This draft will enable interested parties to see the revised measurement proposals in the context of the new standard as a whole. However, the Board is not inviting further comments on aspects of the new standard that it proposed in the 2005 exposure draft. It sought comments on these proposals in 2005 and has considered responses in reaching its decisions on the new standard.

The Board intends to redraft IAS 37 as an IFRS. However, to highlight the extent of the revisions, this exposure draft presents the proposed requirements as amendments to IAS 37.

Invitation to comment

The Board invites comments on the questions set out below. Respondents need not comment on all of the questions. Comments are most helpful if they:

- (a) respond to the questions as stated
- (b) indicate the specific paragraph or paragraphs to which the comments relate
- (c) contain a clear rationale
- (d) describe any alternatives that the Board should consider.

The Board is not requesting comments on matters not addressed in this exposure draft. Comments should be submitted in writing and must arrive no later than **12 April 2010**.

Question 1 – Overall requirements

The proposed measurement requirements are set out in paragraphs 36A–36F. Paragraphs BC2–BC11 of the Basis for Conclusions explain the Board’s reasons for these proposals.

Do you support the requirements proposed in paragraphs 36A–36F? If not, with which paragraphs do you disagree, and why?

Question 2 – Obligations fulfilled by undertaking a service

Some obligations within the scope of IAS 37 will be fulfilled by undertaking a service at a future date. Paragraph B8 of Appendix B specifies how entities should measure the future outflows required to fulfil such obligations. It proposes that the relevant outflows are the amounts that the entity would rationally pay a contractor at the future date to undertake the service on its behalf.

Paragraphs BC19–BC22 of the Basis for Conclusions explain the Board’s rationale for this proposal.

Do you support the proposal in paragraph B8? If not, why not?

Question 3 – Exception for onerous sales and insurance contracts

Paragraph B9 of Appendix B proposes a limited exception for onerous contracts arising from transactions within the scope of IAS 18 *Revenue* or IFRS 4 *Insurance Contracts*. The relevant future outflows would be the costs the entity expects to incur to fulfil its contractual obligations, rather than the amounts the entity would pay a contractor to fulfil them on its behalf.

Paragraphs BC23–BC27 of the Basis for Conclusions explain the reason for this exception.

Do you support the exception? If not, what would you propose instead and why?

Proposed amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*

Paragraphs 36–52, 59 and 60 are deleted. New paragraphs 36A–36F and Appendix B are added. A table of concordance accompanying the exposure draft shows how the paragraphs of IAS 37 and this exposure draft correspond.

Measurement

Initial measurement

- 36A** 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.
- 36B** The amount that an entity would rationally pay to be relieved of an obligation is the lowest of:
- (a) the present value of the resources required to fulfil the obligation, measured in accordance with Appendix B;
 - (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.
- 36C** An entity might be unable to cancel or transfer some obligations within the scope of this Standard. If there is no evidence that an entity could cancel or transfer an obligation for a lower amount, the entity measures the liability at the present value of the resources required to fulfil the obligation.
- 36D** The amount that an entity would have to pay to cancel or transfer an obligation is the price that the counterparty or a third party would demand, plus any costs of cancellation or transfer.

Subsequent measurement

- 36E** An entity shall adjust the carrying amount of a liability at the end of each reporting period to the amount that it would rationally pay to be relieved of the present obligation at that date.
- 36F Changes in the carrying amount of a liability resulting from the passage of time are recognised as a borrowing cost.

Appendix A

Defined terms

This appendix is an integral part of the [draft] Standard.

liability	A present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.
onerous contract	A contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.

Appendix B

Measuring the present value of the resources required to fulfil an obligation

This appendix is an integral part of the [draft] Standard.

The elements of the calculation

- B1 The present value of the resources required to fulfil an obligation shall be estimated taking into account:
- (a) the expected outflows of resources and the time value of money—see paragraphs B2–B14; and
 - (b) the risk that the actual outflows of resources might ultimately differ from those expected—see paragraphs B15–B17.

Expected outflows of resources and time value of money

Expected present value technique

- B2 The amount or timing of the outflows of resources required to fulfil an obligation might be uncertain. In other words, more than one outcome might be possible. All possible outcomes affect the amount that an entity would rationally pay to be relieved of an obligation. The more likely it is that any particular outcome will occur, the greater the effect that the outcome has on the amount that the entity would rationally pay. Thus, if the outcome is conditional on the occurrence or non-occurrence of uncertain future events, the measurement of the liability reflects the uncertainty about these events.
- B3 The range of outcomes and their effects shall be taken into account by estimating the expected present value of the outflows. Estimating the expected present value involves:
- (a) identifying each possible outcome;
 - (b) making an unbiased estimate of the amount and timing of the outflows of resources for that outcome (see paragraphs B5–B13);
 - (c) determining the present value of these outflows (see paragraph B14); and

- (d) 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 outflows for the possible outcomes.

- B4 In some cases, an entity might have access to extensive data and be able to identify many outcomes. In other cases, the information available to the entity might be more limited. Even if there is evidence to support many outcomes, it is not always necessary to consider distributions of literally all possible outcomes using complex models and techniques. Rather, a limited number of discrete outcomes and probabilities can often provide a reasonable estimate of the distribution of possible outcomes.

Estimates of the outflows of resources (paragraph B3(b))

General requirements

- B5 The estimates of the outflows of resources required to fulfil the obligation shall:
- (a) incorporate, in an unbiased way, all available information about the amount, timing and probability of the relevant future outflows.
 - (b) be consistent with observable market prices, if such prices are available.

Relevant future outflows

- B6 The relevant future outflows are those that affect the amount that the entity would rationally pay to be relieved of the present obligation.

Obligations fulfilled by making payments to the counterparty

- B7 If the obligation will be fulfilled by making payments to the counterparty, the relevant outflows include:
- (a) payments to the counterparty; and
 - (b) associated costs, such as external legal fees or the costs of an in-house legal department attributable to that obligation.

Obligations fulfilled by undertaking a service

- B8 Some types of obligation will be fulfilled by undertaking a service at a future date. Subject to the exception in paragraph B9, the relevant outflows for such obligations are the amounts that the entity would rationally pay a contractor at the future date to undertake the service on its behalf:
- (a) if there is a market for a service, the amount is the price that the entity estimates a contractor would charge at the future date to undertake the service on the entity's behalf.
 - (b) if there is not a market for the service, the entity estimates the amount it would charge another party at the future date to undertake the service. The estimates shall include the costs the entity expects to incur and the margin it would require to undertake the service for the other party.
- B9 If the obligation is an onerous contract arising from a transaction within the scope of IAS 18 *Revenue* or IFRS 4 *Insurance Contracts*, the relevant future outflows are the costs the entity expects to incur to fulfil its contractual obligations.

Income tax

- B10 The relevant outflows are measured before tax because IAS 12 *Income Taxes* applies to the tax consequences.

Sources of evidence

- B11 The estimates of the amount, timing and probability of the future outflows are determined by the judgement of the management of the entity, supplemented by experience with similar transactions and, in some cases, input from independent experts. Management needs to ensure that it has used all available evidence to identify the range of possible outcomes and the outflows associated with each, giving more weight to evidence that is more persuasive. The evidence considered includes any additional information provided by events after the reporting period, but only to the extent that the information relates to the obligation existing at the end of the reporting period.

Future events

- B12 An entity takes into account future events that might affect the outflows of resources required to fulfil the present obligation. For example, an entity's experience might indicate that contractor prices for cleaning up a site might reduce in the future as a result of advances in technology. The entity would identify an outcome in which the new technology is available. On the basis of evidence about that technology, it would estimate the effects of the technology on future prices and the probability of the outcome occurring.
- B13 An entity takes into account future events that might affect the outflows of resources without changing the nature of the obligation. However, an entity does not take into account future events—such as a change in legislation—that would change or discharge the present obligation or create new obligations.

Present value (paragraph B3(c))

- B14 The expected outflows shall be discounted to their present value using rates that reflect:
- (a) current market assessments of the time value of money; and
 - (b) risks specific to the liability (but only if and to the extent that the risks are taken into account by adjusting the discount rate rather than by the other methods discussed in paragraph B16).

Risk

- B15 An entity shall consider the risk that the actual outflows of resources might ultimately differ from those expected. A risk adjustment measures the amount, if any, that the entity would rationally pay in excess of the expected present value of the outflows to be relieved of this risk.
- B16 A risk adjustment can be included by:
- (a) adjusting estimates of the future outflows,
 - (b) adjusting the rate used to discount the future outflows to their present values, or
 - (c) calculating the expected present value of the future outflows and adding a risk adjustment to the amount so calculated.

The most appropriate method of including a risk adjustment depends on the nature of the risk and the pattern of the estimated future outflows. If the risk adjustment for a liability is included by adjusting the discount rate, the adjusted discount rate is typically lower than a risk-free rate.

- B17 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 with consequent overstatement of the liability. For example, if the estimated outflows for a particularly adverse outcome are increased to take account of risk, that outcome is not then also treated as more probable than is realistically the case. Similarly, the discount rate does not reflect risks for which future cash flow estimates have been adjusted.

Subsequent measurement

- B18 Paragraph 36E requires an entity to adjust the carrying amount of a liability at the end of each reporting period to the amount that the entity would rationally pay to be relieved of the present obligation at that date. Remeasurement of the present value of the resources required to fulfil the obligation takes into account changes in estimates of:

- (a) the expected outflows of resources;
- (b) market assessments of the time value of money; and
- (c) the risk that the actual outflows of resources might ultimately differ from those expected.

Changes in estimates of the expected outflows of resources could arise from changes in estimates of the amount of the outflows associated with a particular outcome, the timing of those outflows and the probability of the outcome occurring.

- B19 Estimates are subjective. It is important not only that estimates faithfully represent conditions at the end of the reporting period, but also that changes in estimates faithfully represent changes in conditions during the period.

Approval by the Board of *Measurement of Liabilities in IAS 37* published in January 2010

The exposure draft *Measurement of Liabilities in IAS 37* was approved for publication by nine of the fifteen members of the International Accounting Standards Board. Messrs Cooper, Danjou, Engström, Kalavacherla, Smith and Zhang voted against its publication. Their alternative views are set out after the Basis for Conclusions.

Sir David Tweedie Chairman

Stephen Cooper

Philippe Danjou

Jan Engström

Patrick Finnegan

Robert P Garnett

Gilbert Gélard

Amaro Luiz de Oliveira Gomes

Prabhakar Kalavacherla

James J Leisenring

Patricia McConnell

Warren J McGregor

John T Smith

Tatsumi Yamada

Wei-Guo Zhang

Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, Measurement of Liabilities in IAS 37.

- BC1 This Basis for Conclusions summarises the considerations of the International Accounting Standards Board in reaching the conclusions in the exposure draft *Measurement of Liabilities in IAS 37*. Individual Board members gave greater weight to some factors than to others.

Proposals in 2005 exposure draft

- BC2 In June 2005 the Board published an exposure draft of proposed amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and IAS 19 *Employee Benefits* ('the 2005 exposure draft'). The amendments proposed in that exposure draft focused on the recognition requirements in IAS 37. However, the Board also took the opportunity to propose other amendments, including proposals to clarify the IAS 37 measurement requirements.
- BC3 The Board believes that the measurement requirements need to be clearer because:
- (a) *the overall measurement objective is ambiguous.* Liabilities within the scope of IAS 37 typically have uncertain outcomes. Paragraph 36 of IAS 37 requires entities to measure the liabilities at 'the best estimate of the expenditure required to settle the present obligation at the end of the reporting period'. The term 'best estimate' is ambiguous. Accountants often use it to mean 'most likely outcome'. However, paragraph 37 describes it as 'the amount that an entity would rationally pay to settle the obligation at the end of the reporting period or to transfer it to a third party at that time'. Rationally, an entity would pay an amount that is not based solely on the most likely outcome. Rather, it would pay an amount that reflects the probability-weighted average of all possible outcomes. This amount is known as the 'expected value' of the outflows.
 - (b) *additional guidance in IAS 37 does not resolve the ambiguity.* Paragraph 40 states that the best estimate of a single obligation might be the individual most likely outcome. However, it adds that if other outcomes are mostly higher or mostly lower than the most likely outcome, the best estimate will be a higher or lower amount.

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Arguably, this guidance permits measurements based on the most likely outcome only if that outcome is a reasonable estimate of expected value, ie because it is in the middle of the range of possible outcomes. However, many people read it as permitting any individual obligation to be measured by reference to its most likely outcome, possibly with some adjustment if much better or worse outcomes are possible.

- (c) *as a result of the ambiguity, practices vary. This makes it difficult for investors and analysts to compare the financial position of different entities:*
 - (i) entities often measure single obligations on the basis of the most likely outcome, sometimes adjusted to take into account much better or worse outcomes. However, some interpret the term 'best estimate' as permitting measurements based on expected value, or on the minimum or maximum amount in the range of possible outcomes.
 - (ii) entities also include different costs in the estimates of the outflows required to fulfil non-monetary obligations: some include only incremental costs; some include all direct costs; some add indirect costs and overheads; and others estimate the amounts they would pay contractors to fulfil the obligation.

BC4 To address those deficiencies, the Board proposed in the 2005 exposure draft:

- (a) to delete the term 'best estimate' from IAS 37.
- (b) to specify more prominently that the objective is to measure the amount that an entity would rationally pay at the end of the reporting period to settle a present obligation or transfer it to a third party. This objective is based on existing but often overlooked guidance in IAS 37.
- (c) to clarify that, to meet the objective, entities should take into account the probability-weighted average of the possible outcomes, not only the most likely outcome.

Feedback on the 2005 exposure draft

BC5 The proposals would have required many entities to change the way in which they measure liabilities within the scope of IAS 37. Many respondents criticised the measurement proposals on the grounds that:

- (a) the measurement objective was still unclear. It was unclear:
 - (i) whether 'settle' meant fulfil or cancel;
 - (ii) whether a settlement amount might differ from a transfer amount;
 - (iii) if they were different, which of the two amounts should be the basis of the measurement; and
 - (iv) whether and how an entity should estimate the transfer amount for a liability that is impossible or prohibitively expensive to transfer.
- (b) the amount that an entity would pay to cancel or transfer an obligation today is not a relevant measure for liabilities within the scope of IAS 37. Entities are more likely to discharge such liabilities by fulfilling the obligations when they become due.
- (c) measurements based on expected values are less relevant, less reliable and more complex (and hence costly) than those based on the most likely outcome.
- (d) the 2005 exposure draft did not propose any guidance on the types of cost that entities should include in estimates of future outflows. Therefore, inconsistencies in practice would remain.

The Board's responses to the feedback

- BC6 Responding to these criticisms, the Board now proposes:
- (a) to clarify the overall measurement objective (see paragraphs BC9 and BC10);
 - (b) to emphasise that the objective does not require entities to measure liabilities at hypothetical transfer or cancellation prices (see paragraph BC11);
 - (c) to add more guidance on applying expected value techniques—in particular illustrating how the calculations need not be as complex as some people might expect (see paragraphs B2–B4 of Appendix B to the draft Standard); and
 - (d) to specify how an entity should identify and measure relevant future outflows (see paragraphs BC19–BC27 below).

- BC7 The Board considered the criticisms of its proposal to require measurements to be based on expected values rather than the most likely outcomes. However, it did not accept the criticisms and has retained the proposal. The Board explains its reasons in paragraphs BC12–BC18. Having considered the criticisms on several occasions since publishing the exposure draft, the Board does not intend to revisit them. So it has not invited comments on this aspect of the proposals.
- BC8 The only other significant changes that the Board now proposes to the IAS 37 measurement requirements relate to the treatment of future events. The current proposals are the same as those in the 2005 exposure draft, with some points clarified further. They are explained in paragraphs BC28 and BC29.

Proposals in this exposure draft

Measurement objective (paragraphs 36A–36D)

- BC9 Paragraph 36A of the draft standard 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. Paragraph 36B goes on to propose that this amount 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.
- BC10 In the Board’s view, these proposals clarify existing guidance in IAS 37, which states that liabilities should be measured at ‘the amount that an entity would rationally pay to settle the obligation at the end of the reporting period or to transfer it to a third party at that time’. The Board notes that:
- (a) the word rational implies a ‘lowest of’ notion; and
 - (b) the proposed requirements are consistent with the requirements for measuring impaired assets in IAS 36 *Impairment of Assets*. Both approaches capture value-maximising behaviour. An entity measures an impaired asset at the higher of value in use and fair value less costs to sell. Similarly, an entity would measure a

liability within the scope of the proposed standard at the lowest amount payable to settle or otherwise be relieved of the liability.

- BC11 Entities might be unable to cancel or transfer some liabilities within the scope of the proposed standard, or be able to transfer them only at prohibitively high prices. Many of the liabilities are statutory, rather than contractual. Furthermore, a third party might face more uncertainty about the outcome than the entity faces, and so demand a higher price to take on a liability than the entity would rationally pay. The Board does not intend that, in such circumstances, entities should seek to estimate transfer or cancellation prices. Therefore, paragraph 36C clarifies that if there is no evidence that an entity could cancel or transfer an obligation for a lower amount, the entity measures the liability at the present value of the resources required to fulfil the obligation. The Board notes that if an entity could cancel or transfer an obligation for a lower amount, it might have already done so.

The present value of the resources required to fulfil the obligation (Appendix B)

Requirement to measure expected value, not most likely outcome (paragraphs B2–B4)

- BC12 Paragraph B3 proposes that if the outflows of resources required to fulfil a liability are uncertain, an entity should estimate their 'expected value', ie the probability-weighted average of the outflows for the range of possible outcomes.
- BC13 The Board proposed this requirement in the 2005 exposure draft. Many respondents opposed the proposal, arguing that:
- (a) the expected value of the future outflows is not a relevant measure of a liability. Capital providers need information to help them predict the future cash flows of the entity. Except by coincidence, the expected value of the outflows is not an amount that the entity will pay. A more relevant measure of the liability is its most likely outcome.
 - (b) measures of expected value are less reliable than measures of the most likely outcome. They require management to assign values and probabilities to unlikely outcomes. These are the outcomes that are the most uncertain and hence prone to estimation error. To assign precise probabilities to these uncertain outcomes implies a degree of accuracy that does not exist.

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- (c) the calculations are complex and the costs outweigh any benefits. Entities have to obtain more information to measure expected values than to measure most likely outcomes, and this information can be difficult to obtain. Analysts and investors need disclosures about the uncertainties surrounding the outcome of a liability—the amount recognised in the statement of financial position is of little additional benefit.
 - (d) defendants in legal disputes could risk disclosing prejudicial information if required to measure liabilities at their expected values. The amount recognised in the financial statements might disclose to adversaries the amount the defendant would be willing to pay as an out-of-court settlement. Furthermore, in some jurisdictions communications between a defendant and its lawyers could lose their lawyer-client privilege if revealed to auditors. Adversaries could seek discovery of opinions about the possible outcomes.
 - (e) a requirement to measure liabilities arising from legal disputes at expected value would create new differences between IFRSs and US generally accepted accounting principles (GAAP). FASB ASC Subtopic 450-20 *Loss Contingencies* requires entities to measure loss contingencies at the best estimate of the liability, or at the minimum amount in the range of possible outcomes if no individual amount in that range is a better estimate than any other amount.
- BC14 The Board does not agree that the expected value of a liability is a less relevant measure than the most likely outcome, or that disclosures are sufficient on their own:
- (a) Investors and other capital providers need to assess the effect that an obligation has on the value of their claims to the entity's resources. Investors would not be willing to pay as much to invest in an entity that had the obligation. In measuring how much less they would pay, investors would take into account all possible outcomes, not only the most likely one.
 - (b) The management of an entity knows more than the capital providers about the uncertainties surrounding a liability. So capital providers benefit from knowing the amount at which the management of an entity quantifies the entity's obligations.

- BC15 Nor does the Board accept that estimates of expected value are less reliable than estimates of most likely outcome:
- (a) Some think of 'reliability' as referring to the proximity of the estimate of the liability to the actual cash flow subsequently required to settle it. But a difference between the measurement of a liability at one date and the outflows required at a later date is not an indication that the measurement of the liability was wrong. The objective is to measure the liability at the end of the reporting period and to depict the uncertainties at that date, not to predict the entity's future outflows.
 - (b) Many liabilities within the scope of IAS 37 are inherently uncertain and hence prone to a degree of estimation error. However, estimates of expected values are not necessarily less reliable than estimates of the most likely outcome. The main inputs to the calculations—ie the likely future outflows and their timing—are similar. Indeed, measurements that take into account the range of possible outcomes can be less sensitive to estimation error than those that attempt to pinpoint the individual most likely outcome.
 - (c) There may be some, extremely rare, situations in which the outcome of a liability—possibly a major unprecedented lawsuit—is so uncertain that the expected value (and probably also the most likely outcome) cannot be measured reliably. IAS 37 allows for such situations—and the proposed new standard will continue to allow for such situations—by requiring liabilities to be recognised only if they can be measured reliably.
- BC16 The Board considered suggestions that a requirement to measure expected values would be unduly onerous. However, the Board believes that the inputs and models that preparers would need to achieve the overall measurement objective (ie the amount that the entity would pay to be relieved of the obligation) are similar to those they already use to make business decisions. The management of an entity facing legal proceedings needs to obtain evidence of the range of possible outcomes and their probabilities to make decisions about whether to offer an out-of-court settlement and, if so, what amount to offer. Similarly, the management of an entity investing in plant needs to consider the uncertainties surrounding future costs of decommissioning and dismantling plant when making investment appraisal decisions.

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- BC17 The Board has concluded that the proposed measurement requirements will not significantly increase any risk that defendants in lawsuits will disclose prejudicial information to their adversaries:
- (a) Arguably, an entity's estimate of the expected value of a litigation liability, which takes into account the range of different assumptions and inputs, is less revealing than its estimate of the most likely outcome. Moreover, IAS 37 does not require entities to disclose the amount they have recognised for each individual dispute. It requires entities to disclose only the total amounts recognised for each class of liability.
 - (b) Risks associated with loss of lawyer-client privilege exist whether legal opinions concern the most likely outcome or the expected value of the outcomes. Discovery of opinions needed to support an expected value measurement would not be significantly more damaging than discovery of opinions needed to support existing judgements about the most likely outcome.
- BC18 Finally, the Board acknowledges that the measurement requirements proposed in IAS 37 are different from US GAAP requirements. However, the Board does not agree that requiring entities to measure liabilities on the basis of their most likely outcome would contribute to convergence:
- (a) The recognition threshold for litigation liabilities in US GAAP is so high that relatively few liabilities are recognised. Therefore, differences in the measurement requirements would have limited impact in practice. FASB ASC Subtopic 450-20 requires entities to recognise a loss contingency if it is 'probable' that a liability has been incurred. The American Bar Association's *Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information* advises that an unfavourable outcome is probable only if 'the prospects for success by the client in its defense are judged to be slight'.
 - (b) Applying FASB ASC Subtopic 450-20, entities do not always measure loss contingencies by reference to the most likely outcome. If they judge that no individual amount in that range of reasonably possible outcomes is a better estimate than any other amount, they recognise the minimum amount in the range.
 - (c) US GAAP requires some liabilities to be measured at amounts based on expected values. For example, FASB ASC Subtopic 410-20 *Asset Retirement Obligations* requires entities to measure asset retirement obligations initially at fair value and states that 'an expected present value technique will usually be the only appropriate

technique with which to estimate the fair value'. Requiring liabilities within the scope of the proposed standard to be measured at their most likely outcomes would increase differences between US GAAP and IFRS requirements for asset retirement obligations.

Relevant future outflows

Obligations to undertake services (paragraph B8)

- BC19 Some obligations within the scope of IAS 37 are fulfilled by undertaking an activity or service—such as decommissioning plant—at a future date. The Board considered whether the outflows of resources required to fulfil such an obligation would be:
- (a) the expected costs of undertaking the service; or
 - (b) the value of the service, ie the amount that an entity would rationally pay a contractor to undertake the service on its behalf.
- BC20 In favour of measuring the future outflows at the expected costs of undertaking the service, some argue that:
- (a) the amount that a contractor would charge includes a profit margin. Thus if an entity measures a service by reference to contractor prices and then performs the service itself, it recognises a profit when it fulfils its obligation. This is inappropriate because entities receive no proceeds for fulfilling liabilities within the scope of IAS 37.
 - (b) investors want information that helps them estimate the actual future cash flows, not the 'opportunity' cash flows.
 - (c) in the absence of a market for the service, an entity would have to estimate contractor prices using its own estimates of its future costs and adding its own estimates of its required profit margin. The amount of profit would be difficult to define, subjective and open to manipulation. The resulting measurement would not be reliable.
 - (d) the Board does not need to specify market prices to overcome current divergence in practice and impose discipline on measurements. Instead it could provide guidance in IAS 37 on the costs that ought to be included. IAS 2 *Inventories* provides guidance on the costs that should be included in measurement of inventories. IAS 37 could take a similar approach.

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- (e) a requirement to determine contractor prices would be impracticable. Entities would need to obtain external quotes for outsourcing work that they fully intended to carry out themselves.
- BC21 Those in favour of measuring the future outflows by reference to the amount the entity would rationally pay a subcontractor to undertake the service reason that:
- (a) there is a market for most types of service. So, in most situations preparers of financial statements can measure the value of services by reference to observable market prices—they do not have to use their own estimates of costs and margins. The discipline of using market prices reduces subjectivity in measurements. It ensures that similar liabilities are measured at similar amounts irrespective of the preparer's assumptions about the extent to which the entity will employ internal resources rather than contractors to fulfil the obligation. Because many of the obligations will not be fulfilled for some time, intentions could change.
 - (b) unlike measurements based on cost, measurements based on prices have a clear measurement objective, ie the price at which a transaction would take place. Therefore, there is no need for rules on which costs should be included in the measurement, ie on the extent to which entities should include indirect costs and allocate overheads. Any such rules would be essentially arbitrary and, unless very detailed, would not address all situations and could lead to calls for further interpretation.
 - (c) preparers of financial statements would not have to obtain quotes from contractors for each individual obligation. Rather, they would use the same benchmark data about contractor prices that they would have obtained to help them reach rational business decisions about which activities to outsource. Calculations based on contractor prices could be easier to prepare and verify than those based on accumulations of costs and allocations of overheads.
 - (d) the overall measurement objective in IAS 37 is to estimate the amount the entity would rationally pay to be relieved of an obligation. If an entity has an obligation to undertake a service in the future, the amount that it would rationally pay to avoid that obligation would reflect the value—not just the cost—of the resources that it will have to sacrifice to fulfil the obligation. A liability measured in this way provides relevant information to

capital providers—it measures the effect of the obligation on the entity as a whole.

- (e) if an entity measures a liability at cost, it recognises no profit when it carries out the activities necessary to fulfil the liability. However, all of an entity's activities are necessary for it to generate revenue and create value for the capital providers. For example, to produce and sell oil, an entity must construct, operate and decommission an oil rig. The entity should attribute the profit it earns to all of these activities—not just the activities that have been completed when it delivers oil to customers.

BC22 On the basis of the arguments in paragraph BC21, the Board proposes to require entities to measure future outflows of services at the amounts they would rationally pay a contractor to provide the services on their behalf. Paragraph B8 clarifies that if there is a market for the service, the amounts would be the entity's estimates of the amounts a contractor would charge. Acknowledging that a market might not exist for all types of service, B8 also provides guidance on how the entity would estimate the amounts in the absence of a market.

Exception for onerous contracts (paragraph B9)

BC23 IAS 37 defines an onerous contract as a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. At present, entities typically measure onerous contracts in a manner consistent with this definition, ie by comparing the future costs of fulfilling the obligations with the expected economic benefits. However, applying the requirements proposed in paragraph B8, entities would measure some onerous contracts on a different basis—they would measure contractual obligations to undertake a service by reference to a contractor price for, rather than the cost of, the service.

BC24 The proposed requirements would change practice only for onerous contracts that meet all three of the following criteria:

- (a) the contracts are within the scope of IAS 37. Some onerous contracts, such as those within the scope of IAS 11 *Construction Contracts*, are specifically addressed by other standards, so are not within the scope of IAS 37.
- (b) the contracts oblige the entity to undertake a service, ie deliver goods or services. If, in contrast, the contracts required the entity to make cash payments to the counterparty, there would be no

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difference between the unavoidable costs that identified the contract as onerous and the outflows used to measure the contract. In both cases, the relevant amounts would be the future cash payments.

- (c) the contracts oblige the entity to deliver goods or services that it has not (yet) recognised as assets in its statement of financial position. Otherwise, the entity would recognise an impairment loss on the asset, not a separate onerous contract liability.

BC25 Some transactions within the scope of IAS 18 *Revenue* or IFRS 4 *Insurance Contracts* fulfil all three of these criteria.

BC26 The Board is undertaking projects to develop new standards to replace both IAS 18 and IFRS 4. In those projects, the Board is considering how entities should account for onerous contracts arising from transactions within the scope of these standards. In December 2008 the Board published a discussion paper *Preliminary Views on Revenue Recognition in Contracts with Customers*. The discussion paper proposed that the standard that replaces IAS 18 should require entities to use cost as the basis for both recognising and measuring onerous sales contracts.

BC27 The Board wishes to avoid imposing changes in practice now that it might or might not reverse when it issues new standards to replace IAS 18 and IFRS 4. Therefore, paragraph B9 proposes measurement requirements that would temporarily allow entities to continue their present practices for onerous contracts that arise from transactions within the scope of IAS 18 and IFRS 4. When the Board issues new standards, it will either confirm the exception (possibly removing the contracts from the scope of IAS 37) or delete it (bringing treatment of onerous sales and/or insurance contracts into line with the requirements for other liabilities within the scope of IAS 37).

Future events (paragraphs B12 and B13)

BC28 IAS 37 states that entities should take into account future events that might affect the outcome of the obligation *only* if there is sufficient objective evidence that these events will occur. The Board believes that this requirement conflicts with the overall objective of measuring the amount the entity would rationally pay to be relieved of the obligation. Rationally, an entity would take into account all material outcomes, not only those that evidence suggests *will* occur. In the 2005 exposure draft the Board proposed to remove the requirement. The Board received broad support for the proposal and has therefore retained it.

BC29 IAS 37 requires entities to take into account the effect of possible new legislation when measuring the present obligation if there is sufficient objective evidence that the legislation is virtually certain to be enacted. The Board does not believe that future changes in legislation affect the amount required to settle the *present* obligation. Rather, they change the nature of the obligation, or create new obligations. Hence, in the 2005 exposure draft the Board proposed that entities should not take into account future events—such as new legislation—that create new obligations or change the present obligation. The Board received broad support for the proposal and has therefore retained it.

Due process procedures

BC30 The Board received comments on many aspects of the proposals in the 2005 exposure draft. To understand the comments more fully, the Board held round-table meetings in 2006 and later invited representatives of the legal profession to a Board meeting. Since then, it has been considering the feedback it received during these consultations.

BC31 In response to the feedback, the Board has revised a number of the proposals. A full list of the proposed revisions is in a decision summary linked to the project page of the IASB website. The Board is re-exposing the revised measurement proposals for comment because they are significantly different from the original proposals and raise issues that were not aired in the 2005 exposure draft. The Board is also preparing a working draft of the proposed new standard and aims to post a copy on its website in February 2010. That draft will enable interested parties to see the revised measurement proposals in the context of the new standard as a whole.

BC32 The Board has decided not to re-expose the entire standard for further comment because it exposed all of the main proposals, other than the measurement proposals, in the 2005 exposure draft. The Board has thoroughly considered comments on the 2005 exposure draft and does not believe it needs to consider them again. The Board will explain its conclusions on the proposals that it is not re-exposing in the Basis for Conclusions accompanying the revised standard. It intends to make a draft of the Basis for Conclusions available on its website alongside the working draft standard.

Alternative views on exposure draft

Alternative views of Stephen Cooper, Philippe Danjou, Jan Engström, Prabhakar Kalavacherla, John T Smith and Wei-Guo Zhang

- AV1 Messrs Cooper, Danjou, Engström, Kalavacherla, Smith and Zhang voted against the publication of the exposure draft *Measurement of Liabilities in IAS 37* for the reasons set out below.

Profit margin

- AV2 Paragraph B8 of Appendix B proposes that an entity should measure a liability to undertake a service by reference to the amount it would rationally pay a contractor to perform the service on its behalf. The estimate of this amount would include an explicit profit margin that the entity would charge for the service, or an implicit margin in the price that a contractor would charge. These six Board members disagree with the proposal in paragraph B8 for the following reasons.
- (a) They believe that obligations arising outside contracts with customers are different from those arising from contracts with customers, under both IAS 18 *Revenue* and the proposed customer consideration approach in the revenue recognition project. In contracts with customers, both the performance obligation and the revenue to be recognised are objectively measured at the amount of consideration under the contract. If the customer pays that consideration at inception, the performance obligation recognised includes any profit margin but it is an implicit profit margin, not an explicit margin.
 - (b) In contrast, if an entity expects to fulfil an obligation in the scope of IAS 37 by undertaking the service itself, the margin that the entity would have charged a customer or a margin that a contractor would have charged the entity for the activity is non-existent. It is a hypothetical amount that does not represent a payment of cash or an actual outflow of the entity's resources. Including a hypothetical margin in the measurement of the liability would reduce the net profit at the initial recognition of the liability and release a profit in the period in which the liability is derecognised. These Board members believe that such accounting creates inappropriate performance information for both periods and does not provide useful information to the users

of financial information. They also believe that such a measurement method does not help in predicting the entity's capacity to generate cash flows in the future.

- (c) Paragraph B8 requires an entity to refer to the price a contractor would charge, if a market exists. The Board asserts in paragraph BC21(a) that there is a market for most types of service. These six Board members disagree. Furthermore, there is no guidance about what constitutes a market and whether a referenced market should be a liquid market with observable market prices. There is also no guidance about how to determine the margin when there is not a market for the service. In the view of these six Board members, the lack of guidance will lead to unacceptably wide variation in the margins that different entities include for similar obligations and provide a means of earnings management.

AV3 The Board is addressing the measurement of performance obligations in two other projects (revenue recognition and insurance contracts) that are scheduled to be completed after the completion of the project to amend IAS 37. These Board members are concerned that if the requirement to include an explicit margin in the measurement of the liability is adopted, it will establish the principle for measuring obligations, specifically onerous performance obligations, in the other projects. They also note that paragraph B9 proposes an exception for onerous contracts arising from transactions within the scope of IAS 18 or IFRS 4 *Insurance Contracts* to avoid changes in practice that the Board might reverse when it issues new standards, and they believe that, given the purpose of this exception, it should also apply to other liabilities, such as warranty obligations, that arise from transactions within the scope of IAS 18.

AV4 These Board members believe that an obligation to provide a good or service within the scope of IAS 37 should be measured at the expected cost of fulfilling the obligation. In many instances this will be the price the entity must pay a contractor to provide the good or to perform the service, which will represent its fulfilment cost. However, if the entity expects to fulfil the obligation by undertaking the service itself, the amount should be the costs it will incur to fulfil the obligation. These costs should include both direct cash flows arising from fulfilment and the indirect costs of using the entity's existing resources in the fulfilment process.

Risk margin

- AV5 Messrs Cooper, Danjou, Engström, Kalavacherla, Smith and Zhang also disagree with the lack of guidance regarding the circumstances in which a risk adjustment should be included in the measurement of a liability and how such a risk adjustment should be determined. In their view, it is not clear what this adjustment is intended to represent. The adjustment could be interpreted as being for uncertainty about the extent to which the probability estimates are accurate. It could be interpreted as a benefit for transferring the risk or an additional safety margin. It is also not clear whether the risk adjustment should consider the extent to which risk is diversifiable. In their view the lack of guidance concerning the risk adjustment is likely to result in significant diversity in practice.
- AV6 These six Board members agree that the amount an entity would rationally pay to be relieved of an obligation could include a benefit from not being exposed to risks in addition to a reduction in expected cash outflows. However, they believe that any risk adjustment must take account of the extent to which these risks are diversifiable and that, for many liabilities, where the potential variation in cash flows is due to factors specific to that liability, a risk adjustment would be inappropriate. The inclusion of a risk margin in these circumstances would be inconsistent with the overall measurement objective in the exposure draft and would effectively constitute an additional profit margin, the objections to which are outlined above. They believe that the exposure draft should have specified that a risk adjustment should be included only to the extent that the risk is non-diversifiable: no risk adjustment should be included for risks that are diversifiable.

Due process

- AV7 Messrs Danjou and Engström further think that because measurement objectives and methods on one hand, and recognition criteria on the other hand are closely related, the Board should re-expose the entire proposed standard, not only the proposed measurement requirements. Most respondents to the 2005 exposure draft opposed—and continue to oppose—aspects of the proposals that the Board is not now re-exposing. The revised measurement proposals are significantly different from the original proposals and raise issues that were not aired in the 2005 exposure draft, and Messrs Danjou and Engström think it is likely that many preparing responses to the measurement proposals will not have

commented on the 2005 exposure draft. The Board expects to have a working draft of the standard available within two months, so it could, without significant delay, re-expose the proposed measurement requirements within the context of the proposed standard as a whole.

[Draft] Illustrative example

This [draft] example accompanies, but is not part of, the Standard.

Measurement of obligation to dismantle an asset

Facts

An oil production company owns and operates an oil rig. Existing environmental laws oblige rig owners to dismantle rigs that have reached the end of their useful lives.

Rig owners cannot cancel such obligations, or transfer them to a third party. However, there are contractors in the market that provide dismantling services for rig owners. A contractor would charge 125,000 currency units (CU125,000) to dismantle the oil company's rig now, in a way that complies with existing environmental laws.

The rig has an estimated remaining useful life of 10–15 years. The current 10-year and 15-year risk-free rates of interest are respectively 6 and 5.5 per cent per year.

Measurement basis

Because the oil company cannot transfer or cancel its obligation, it need not consider the amounts it would have to pay to do so. It measures the liability as the present value of the resources required to fulfil the obligation. It applies the present value techniques described in Appendix B to the Standard.

Outflows of resources

The relevant outflows are the amounts that the entity estimates a contractor would charge at the end of the rig's useful life to dismantle the rig at that time. The entity estimates this amount taking into account the price that a contractor would charge to undertake this work now (CU125,000) and estimates of future price increases.

Estimates of future price increases take into account possible market and technological developments. The entity estimates the probability of these developments occurring on the basis of experience, market data, technological information and similar evidence. The estimates of future prices are based on existing legal requirements: they do not take into account the possibility that the legal requirements will be more onerous at the end of the rig's useful life than they are at present.

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The entity identifies six outcomes that represent a reasonable estimate of the distribution of possible outcomes. The entity discounts the estimated outflow for each of the six outcomes to its present value:

Outcome	Useful life of rig	Estimated outflow (contractor price) CU	Discount rate %	Present value of outflow CU
1	10 years	200,000	6%	111,679
2	10 years	225,000	6%	125,639
3	10 years	275,000	6%	153,559
4	15 years	230,000	5.5%	103,025
5	15 years	260,000	5.5%	116,463
6	15 years	340,000	5.5%	152,297

Expected present value of the outflows

The entity estimates the probability of each outcome occurring. It calculates the probability-weighted average of the present values for the six outcomes. This amount is the expected present value of the outflows.

Outcome	Estimated probability	Present value of outflow (from previous table) CU	Present value × probability weighting CU
1	5%	111,679	5,584
2	25%	125,639	31,410
3	20%	153,559	30,712
4	5%	103,025	5,151
5	25%	116,463	29,116
6	20%	152,297	30,459
Expected present value of outflows			132,432

Risk adjustment

The CU125,000 that a contractor would charge to dismantle the rig includes a price for risk, but only in respect of uncertainties in the costs that the contractor would incur to dismantle the rig now. It does not take into account the additional risk that arises because of uncertainty about:

- (a) how prices will change between now and the end of the rig's useful life; and
- (b) when the rig will reach the end of its useful life.

The entity estimates that it would rationally pay an additional 5 per cent to be relieved of this risk:

	CU
Expected present value of outflows (from previous table)	132,432
Risk adjustment (5%)	6,622
The amount the entity would rationally pay at the end of the reporting period to be relieved of the obligation	<u>139,054</u>

Table of Concordance

This table shows how the contents of this exposure draft correspond with those in IAS 37 and in the previous exposure draft of proposed amendments to IAS 37, published in June 2005. Paragraphs are treated as corresponding if they broadly address the same matter, even though the guidance may differ.

Paragraph(s) of IAS 37	Paragraph(s) of this exposure draft	Paragraph(s) of 2005 exposure draft
36 and 37	36A–36D	29 and 30
38	B11	32
39 and 40	B2–B4	31 and 33
None	B5–B9	None
41	B10	34
42	B1, B15 and B16	35
43	B17	36
44	None (guidance on disclosures will be located elsewhere in the IFRS)	37
45–47	B14	38–40
48 and 49	B12	41 and 42
50	B13	42
51 and 52	None	None
59	36E	43
None	B18 and B19	44
60	36F	45