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IASB refines proposals for the measurement of liabilities in IAS 37

Background

In 2005, the International Accounting Standards Board (IASB) published an exposure draft (the '2005 ED') of the International Financial Reporting Standard (IFRS) to replace IAS 37 *Provisions, Contingent Liabilities and Contingent Assets.* Following consideration of the responses received to the 2005 ED, on 5 January 2010 the IASB published ED/2010/1 (the '2010 ED') *Measurement of Liabilities in IAS 37 (Limited re-exposure of proposed amendment to IAS 37).* The 2010 ED deals with only one section of the proposed replacement Standard and addresses the measurement requirements for liabilities that are within the scope of IAS 37. The 2010 ED:

- clarifies the measurement objective;
- emphasises that liabilities should not be measured at hypothetical transfer or cancellation prices;
- adds guidance on applying expected value techniques; and
- specifies how to identify and measure relevant future outflows.

Other changes to the proposals contained in the 2005 ED will not be re-exposed, because the Board considers that they are relatively minor. However, to assist constituents in understanding the refined measurement guidance proposed in the 2010 ED within the context of the rest of the proposed Standard, a staff paper has been made available on the IASB's website[1] summarising the decisions reached since the 2005 ED. In addition, the IASB will publish a working draft of the proposed new IFRS (incorporating the 2010 ED guidance) on its website during February 2010. The 2010 ED is open for comment until 12 April 2010 and the IASB plans to issue the final new IFRS in the third quarter of 2010.

Principal features of the proposed measurement guidance

Currently, IAS 37.36 requires a liability to be measured at "the best estimate of the expenditure required to settle the present obligation". In addition, IAS 37.37 explains that "the best estimate of the expenditure required to settle the present obligation is 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". These measurement requirements have been criticised as vague and have resulted in diversity in practice. The 2005 ED attempted to address these concerns by removing the term 'best estimate' and elevating the explanation in IAS 37.37 to a measurement principle. Constituents were still unclear as to what was meant by 'settle' in this context and were concerned that the proposals of the 2005 ED could potentially lead to further diversity in practice.

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1 The decision summary is available on http://iasb.org/Current+Projects/IASB/Liabilities/Liabilities.htm

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In response to these concerns, the 2010 ED retains the measurement principle of the 2005 ED but with expanded explanations and guidance. The principle proposed is to require that a liability should be measured at the amount that the entity "would rationally pay at the end of the reporting period to be relieved of the present obligation". The 2010 ED proposes that that amount should be determined as the lowest of:

- the present value of the resources required to fulfil the obligation; or
- the amount an entity would have to pay to cancel the obligation; or
- the amount an entity would have to pay to transfer the obligation to a third party.

Under the proposals, the amount an entity would have to pay to cancel or transfer the obligation is the price that the counterparty or a third party would demand, plus any costs of cancellation or transfer. If there is no evidence that an entity could cancel or transfer an obligation for a lower amount, the entity should measure the liability at the present value of the resources required to fulfil the obligation.

The 2010 ED further proposes that changes in the carrying amount of a liability resulting from the passage of time subsequent to initial measurement should be recognised as a borrowing cost.

Measuring the present value of resources required to fulfil the obligation

The 2010 ED proposes that the present value of the resources required to fulfil an obligation should be estimated taking into account:

- the expected outflow of resources and the time value of money; and
- the risk that actual outflows might differ from those expected.

Expected present value methodology

The proposed measurement guidance states that when the amount or timing of outflows of resources is uncertain, an entity should estimate their expected value (i.e. estimate the probability-weighted average of the outflows for the range of possible outcomes). The 2010 ED further clarifies that the expected value calculations need not be complex and that a limited number of discrete outcomes and probabilities can often provide a reasonable estimate. Although the expected value is unlikely to be equal to the amount that is ultimately paid, the IASB believes that it is a relevant measure for capital providers when assessing the effect of a liability on the value of their claims to the entity's resources.

Relevant future outflows

If an obligation is to pay cash to the counterparty, the 2010 ED proposes that the future outflow of resources should be the expected cash payments plus any associated costs (e.g. external or in-house legal fees). However, when the obligation is to undertake a service at a future date and there is a market for the service, the 2010 ED would require that the outflows be the amounts that the entity would rationally pay a contractor at the future date to undertake the service on its behalf. When there is not a market for the service, the 2010 ED requires the entity to estimate the amount it would charge another party at the future date to undertake the service, based on the costs the entity expects to incur and the profit margin it would require to undertake the service.

The explicit inclusion of a profit margin in the proposed measurement of a liability has caused six of the fifteen IASB members to dissent from the 2010 ED. These IASB members are concerned that including a hypothetical profit margin in the measurement of a liability would lead to inappropriate financial performance information at initial recognition and in the period in which the liability is derecognised.

Estimates of the amount, timing and probability of the future outflows would be based on management's judgement supplemented by experience with similar transactions and, in some cases, input from independent experts.

The 2010 ED proposes a limited exception from the measurement principle applying to obligations that are fulfilled by undertaking a service for onerous contracts arising from transactions within the scope of IAS 18 *Revenue* or IFRS *4 Insurance Contracts.* Such contracts should continue to be measured by reference to the costs the entity expects to incur to fulfil its contractual obligations, so as not to result in a change in practice for measuring onerous sales and insurance contracts pending the completion of the relevant projects of the IASB.

Discount rate

The 2010 ED further proposes that the rate used to discount the expected outflows to their present value should reflect current market assessments of the time value of money and those risks that are specific to the liability (unless the risks are taken into account using one of the other two methods proposed in the 2010 ED – see below).

Risk adjustments

The 2010 ED proposes that an entity should incorporate the risk that the actual outflow of resources might differ from those expected by measuring the amount that the entity would rationally pay in excess of the expected present value of the outflows to be relieved of this risk. The adjustment may be included by adjusting estimates of future outflows, the discount rate used or by calculating the expected present value of the future outflows and adding a risk adjustment to that.

Illustrative example – IAS 37 vs proposals in the 2010 ED

Entity A is defending a legal claim by a customer for CU 1 million. Based on legal advice, Entity A's management estimate that there is a 40% likelihood that the claim will be successful and that Entity A will be required to pay CU 1 million to the customer; the likelihood the Entity A will defend the claim and not be required to pay anything to the customer is 60%.[2]

Under the existing requirements of IAS 37, in the circumstances described no provision would be recognised because an outflow of resources is not considered 'probable' (i.e. more likely than not). The legal claim meets the definition of a contingent liability and appropriate disclosures should be made in accordance with IAS 37.86.

The 2005 ED included proposals to remove the 'probability of outflows' criterion from the recognition principle in IAS 37 and instead to reflect the probability of outflows in the measurement. The revised requirements would lead to the recognition of all liabilities that could result in an outflow of resources, even if the likelihood of such an outflow is low. Therefore, under the proposals, in the circumstances described a liability would be recognised because the legal claim could result in an outflow of resources. The decision summary on the IASB's website indicates that the Board reconfirmed its previous decision to remove the probability recognition criterion in any final Standard.

Using the detailed guidance proposed in the 2010 ED and assuming that there is a 5% risk that the actual outflow of resources may differ from that expected, the liability would be measured as follows:

Measure at expected value
(i.e. probability-weighted average of the outflows for the range of possible outcomes

Outcome (present value)	Probability	Amount
CU 1,000,000	40%	CU 400,000
CU 0	60%	CU 0
		CU 400,000
	Risk adjustment (5%)	CU 20,000
	Total	**CU 420,000**

2 It is assumed that a present obligation exists

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