

iGAAP Alert Measurement of Liabilities in IAS 37

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In a nutshell

In order to finalise the new standard to replace IAS 37 the IASB has issued a limited exposure draft on the measurement requirement.

It is proposed that a non-financial liability would be measured at the amount that the entity would rationally pay to be relieved of the obligation. This will be lowest of the amounts to fulfil, to cancel, or to transfer the obligation.

The uncertainty in expected cash outflows would be reflected in the measurement of the obligation. The entity would estimate the liability using a probability-weighted average of the expected outflows and incorporate a risk adjustment to reflect that the outflows might differ from those expected.

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Background

In 2005, the International Accounting Standards Board (IASB) published an Exposure Draft of proposed amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* (original ED).

The changes proposed reflected the IASB's view that an item meeting the definition of a liability for which the settlement amount is contingent on one or more uncertain future events should be recognised irrespective of the probability of the uncertain future event(s) occurring. Hence, the probability threshold for recognition of a liability would be removed with the uncertainty instead reflected in the measurement of the liability.

The IASB has now reviewed its original proposals in the light of comment letters received and has, in summary, decided to proceed with the majority of the proposals, albeit with a number of clarifications and revisions.

During discussions it became apparent that the measurement requirement proposed for liabilities in the original ED was not clear. Therefore, the IASB has issued a new ED *Measurement of Liabilities in IAS 37 (2010 ED)* that addresses the measurement requirements for liabilities only. This Alert focuses on the proposals of the 2010 ED.

Measurement principle

The principle proposed in the standard 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 original ED proposed that non-financial liabilities should be measured at the amount that an entity would rationally pay to **settle** the present obligation or **transfer** it to a third party on the balance sheet date. Many respondents found

this proposal unclear, especially questioning what 'settle' meant.

The new ED explains the principle and proposes that non-financial liabilities should be measured at the lowest of:

- the present value of resources required to **fulfil** the obligation;
- the amount the entity would have to pay to the counterparty to **cancel** the obligation; and
- the amount the entity would have to pay to a third party to **transfer** the obligation to that party.

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.

Expected outflows - obligations to make payments

Where the obligation will be fulfilled by making payments to the counterparty, the relevant outflows will include not only payments to the counterparty, but also associated costs (e.g. external legal fees or the costs of an in-house legal department attributable to that obligation).

Expected outflows - obligations to undertake service

Some obligations will be fulfilled by undertaking a service at a future date (e.g. decommissioning plant). When the obligation is to undertake a service at a future date and there is a market for the service, the 2010 ED proposes that the outflows be the amounts that the entity estimates a contractor would charge at the future date to undertake the service on its behalf. When there is not a market for the service, the 2010 ED proposes that the entity estimates 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 out of 15 IASB members to dissent from the 2010 ED.

Uncertain outflows

The 2010 ED supports the use of expected cash flow estimation techniques. If the outflows of resources required to fulfil the obligation are uncertain, the entity would estimate the expected value using a probability-weighted average of the outflows for the range of possible outcomes. The 2010 ED clarifies that the expected value calculations need not be complex.

As proposed in the original ED, the notions of "provision" and "contingent liability" would be abandoned. Where a present obligation exists, a non-financial liability would be recognised and the uncertainty relating to the amount would be reflected in its measurement.

Discount rate

The 2010 ED further proposes that the rate used to discount the expected outflows to their present value should reflect the current market assessment 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 outflows 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 present value of the future outflows and adding a risk adjustment to that.

Comment deadline

The proposed new standard including these latest proposals would bring significant changes to IAS 37:

- the title of the new standard would be changed to "Non-financial liabilities". This change is intended to clarify that the new standard would be wider in scope than the current IAS 37 and would apply to all non-financial liabilities that are not within the scope of other standards;
- the term "provision" currently used in IAS 37 would be replaced by "non-financial liability";
- the probability threshold and the concept of a "contingent liability" would be abandoned. Where a present obligation exists, a non-financial liability would be recognised and the probability of outflow of amounts would be reflected in the measurement;
- where there is uncertainty of whether a present obligation exists, a "possible obligation" would be disclosed.

The comment deadline for the measurement principles for non-financial liabilities discussed in this Alert is 12 April 2010. For those who would like to consider the fuller and updated picture the proposed text of the entire standard, including the wording from the new ED, will be posted in the IASB's website in February 2010. In the meantime, the summary of the decisions reached since publishing the original ED is available in the IASB's website.

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