New on the Horizon: Measurement of liabilities in IAS 37

International Financial Reporting Standards
March 2010
Foreword

Back in 2005, when the IASB published an exposure draft to revise its provisions standard, most people would not have predicted that five years would pass without resolution of the issues put into play. The consultation document that is the subject of this New on the Horizon publication is the long-delayed next step. However, this next step is a limited one as the 2010 exposure draft focuses only on certain aspects of the measurement requirements.

While the 2010 exposure draft has a narrow focus, its proposals are nevertheless significant. The IASB is proposing an approach to the measurement of provisions for items such as restoration obligations that appears to be based on a measure of “value” rather than “cost to fulfil” – including a third-party profit margin even if that “cost” is not expected to be incurred. These proposals, along with other planned requirements that are not being exposed, such as the requirement to use a probability-weighted expected value approach to measure all obligations, could result in significant changes from current practice in accounting for provisions, contingent liabilities and contingent assets.

This project has taken a back seat over the past few years as the IASB has focused on responding to the global financial crisis and the projects that are part of its Memorandum of Understanding with the US Financial Accounting Standards Board. The IASB now is hoping to bring this project to a close in the second half of 2010 with a comprehensive new standard. Whether they succeed will depend in part on the level of support received in response to this latest invitation to comment.

We hope this publication will help you gain a greater understanding of these proposals and we encourage all interested parties to be part of this debate by expressing their views to the IASB before the comment deadline of 19 May.

Phil Dowad (Chair)
Catherine Morley (Vice-chair)
Bruce Darton
Mary Tokar
KPMG’s global IFRS Revenue Recognition and Provisions leadership team
KPMG International Standards Group
About this publication

This publication has been produced by the KPMG International Standards Group (part of KPMG IFRG Limited).

We would like to acknowledge the efforts of the principal authors of this publication. The principal authors include Eamon Dillon, Catherine Morley and Mary Tokar of the KPMG International Standards Group.

Content

Our New on the Horizon publications are prepared upon the release of a new proposed IFRS or proposed amendment(s) to the requirements of existing IFRSs. They include a discussion of the key elements of the new proposals and highlight areas that may result in a change of practice.

This edition of New on the Horizon considers the proposed requirements of Measurement of Liabilities in IAS 37 – Proposed amendments to IAS 37 (2010 ED). It also provides a high-level overview of some significant changes to current practice expected in the accounting for provisions that are not re-exposed as part of the 2010 ED.

The text of this publication is referenced to the 2010 ED and to selected other current IFRSs in issue at 28 February 2010. References in the left-hand margin identify the relevant paragraphs.

Further analysis and interpretation will be needed in order for an entity to consider the potential impact of this ED in light of the entity's own facts, circumstances and individual transactions. The information contained in this publication is based on initial observations developed by the KPMG International Standards Group, and these observations may change.

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- IFRS Handbooks, which include extensive interpretative guidance and illustrative examples to elaborate or clarify the practical application of a standard, including IFRS Handbook: First-time adoption of IFRSs
- New on the Horizon publications, which discuss consultation papers
- Newsletters, which highlight recent developments, including IFRS – Insurance Newsletter
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- Disclosure checklist.

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1. Executive summary

- The Measurement of Liabilities in IAS 37 – Proposed amendments to IAS 37 exposure draft (2010 ED) is part of the International Accounting Standards Board’s (IASB or Board) project to replace IAS 37 Provisions, Contingent Liabilities and Contingent Assets with a new IFRS on liabilities. Significant changes to current practice under IAS 37 are expected in the replacement standard; many of those changes are not re-exposed in the 2010 ED.

- The 2010 ED is a limited scope re-exposure focused on the following aspects of the proposed measurement requirements for liabilities:
  - Establishing a high-level measurement objective for liabilities and certain aspects of application of that measurement objective.
  - Measuring obligations involving services (e.g. decommissioning) by reference to the price that a contractor would charge to undertake the service, i.e. including a profit margin. This would be irrespective of the entity’s intentions with regard to settling the obligation, i.e. irrespective of whether the entity intends that the work will be carried out by an in-house team or by external contractors.
  - Excluding from the proposed measurement requirements onerous sales and insurance contracts within the scope of IAS 18 Revenue and IFRS 4 Insurance Contracts. The objective is to continue with current practice for the measurement of such obligations for the time being, since the Board has current projects on revenue and insurance contracts.

- The proposed high-level measurement objective for liabilities is the amount that an entity rationally would pay at the end of the reporting period to be relieved of the present obligation. This would be the lowest of: (i) the present value of the resources required to fulfil the obligation; (ii) the amount that the entity would have to pay to cancel the obligation; and (iii) the amount that the entity would have to pay to transfer the obligation to a third party. We expect that the fulfil approach would be the one used most commonly in practice.

- As part of this project the Board has decided to mandate the use of expected present value to measure not only large populations of similar items but also single obligations (e.g. lawsuits). This would represent a significant change to current practice as current practice is to measure single obligations at their most likely outcome. The Board is not inviting comments on this in the 2010 ED.

- The 2010 ED proposes that a “risk adjustment” be included in the measurement of liabilities for the amount that the entity rationally would pay in excess of the expected present value of the probability-weighted outflows to be relieved of the risk that actual outflows may differ from the expected present value calculation. This is likely to be one of the most challenging aspects of the 2010 ED.

- The 2010 ED proposes that when measuring liabilities, an entity takes into account future events that might affect the outflow of resources without changing the nature of the obligation.
2. Introduction and background

In 2005 the IASB published an exposure draft of *Proposed Amendments to IAS 37 Provisions, Contingent Liabilities and Contingent Assets and IAS 19 Employee Benefits* (2005 ED). The Board has redeliberated the proposals in the 2005 exposure draft and intends to issue a new IFRS on liabilities to replace IAS 37. The replacement standard is expected to result in significant changes from current practice in accounting for provisions, contingent liabilities and contingent assets; many of these changes are not being re-exposed as part of the 2010 ED. The 2010 ED is a limited scope re-exposure focused only on certain aspects of the measurement of liabilities. The Board is not inviting comments on other aspects of the project.

The IASB cites its overall objectives for the liabilities project as including: to align the criteria for recognising a liability with those in other IFRSs; to eliminate some differences between IFRSs and US Generally Accepted Accounting Principles (US GAAP); and to clarify the measurement requirements for liabilities. The 2010 ED relates to the last of these objectives. The liabilities project is linked closely to the Board’s current *Conceptual Framework* project, which involves a fundamental reconsideration of the definition and measurement of a liability.

The IASB acknowledges that the current IAS 37 measurement requirements are not specific and therefore there is diversity in practice in this area. The Board’s initial attempt to address all three overall objectives was the 2005 ED. The comment letters received by the Board raised significant challenges to the clarity and consistency of those proposals; the Board tentatively has concluded on a number of changes to try to address some of those concerns. The Board decided to re-expose the proposed measurement requirements to test both the measurement objective (what entities should be measuring) and measurement guidance (how to satisfy the measurement objective).

The IASB decided not to re-expose the entire replacement standard because it believes that it is only in the area of measurement that the replacement standard would differ significantly from the proposals in the 2005 ED. The Board believes that other changes that it has made are either minor or in response to feedback received. In addition, the Board believes that it has considered thoroughly comments received on the 2005 ED and that it does not need to consider them again.

While the IASB is not inviting comments on aspects of the liabilities project not exposed in the 2010 ED, it published a working draft of the replacement standard on its website on 19 February 2010 for the information of constituents.

Six Board members dissented to publication of the 2010 ED. The dissenting Board members expressed concerns around the proposal to include a profit margin in the measurement of service-related liabilities, the proposal to include a risk margin in the measurement of liabilities and due process.

In addition to providing an overview of the proposals in the 2010 ED, this publication also provides a high-level overview of some significant changes to current practice expected in the area of provisions that are not re-exposed as part of the 2010 ED.
3. Overview of the 2010 ED

The 2010 ED is a limited re-exposure focused on the following aspects of the proposed measurement requirements for liabilities not covered by another standard:

- Establishing a high-level measurement objective for liabilities and certain aspects of application of that measurement objective (see 3.1).
- Measuring obligations involving services, e.g. decommissioning (see 3.2) by reference to the price that a contractor would charge to undertake the service, i.e. including a profit margin. This would be irrespective of the entity’s intentions with regard to settling the obligation, i.e. irrespective of whether the entity intends that the work will be carried out by an in-house team or by external contractors.
- Excluding from the proposed measurement requirements onerous sales and insurance contracts within the scope of IAS 18 and IFRS 4 (see 3.3). The objective is to continue with current practice for the measurement of such obligations for the time being, since the Board has current projects on revenue and insurance contracts.

Since the 2010 ED focuses on a small section of a full IFRS, in this publication we provide background to the specific questions in the 2010 ED in order to help understand the questions being asked. In doing this, we highlight what the Board is and is not inviting comments on in the 2010 ED.
3.1 Proposal 1: Measurement objective

3.1.1 High-level measurement objective for liabilities

In the 2010 ED the Board proposes that the measurement objective for liabilities is the amount that an entity rationally would pay at the end of the reporting period to be relieved of the present obligation. This would be the lowest of:

- the present value of the resources required to *fulfil* the obligation;
- the amount that the entity would have to pay to *cancel* the obligation (including costs of cancellation); or
- the amount that the entity would have to pay to *transfer* the obligation to a third party (including costs of transfer).

Measurement would be based on the lowest of the three amounts, if there is evidence that an obligation could be cancelled or transferred; otherwise an obligation would be measured using the fulfil approach. In the 2010 ED the Board states that it is not requiring estimation of a hypothetical transfer amount for obligations that cannot be transferred or that can be transferred only at an amount higher than the entity rationally would pay. The following diagram illustrates the high-level measurement objective:

We expect that the “fulfil approach” will be the approach used most commonly in practice to measure liabilities because many obligations within the scope of the liabilities standard cannot be cancelled or transferred. In addition, if an obligation could be cancelled or transferred for an amount lower than the amount to fulfil it, then the Board believes that it is likely that an entity would have done so already.

The high-level measurement objective is a current settlement notion, i.e. it calculates what an entity rationally would pay today to be relieved of a present obligation that it is not required to fulfil until some time in the future. For example, Company P has an obligation to dismantle an oil rig in ten years’ time. When measuring the liability P calculates the amount that it rationally would pay today to be relieved of the present obligation to dismantle an oil rig in ten years’ time; P is not calculating the amount to dismantle the oil rig today. See 3.1.3 and 3.2 for further information on measuring the liability.

Observation – value approach

Although the wording is not explicit, it appears that the measurement objective proposed in the 2010 ED is a value-based approach rather than a cost-based approach. For example, in the case of a service-related obligation the 2010 ED proposes measuring the obligation at the value of the service, i.e. include a profit margin even if the entity intends to perform the service in-house (see 3.2). In addition, the 2010 ED proposes to include a risk adjustment in the measurement of obligations (see 3.1.3).
3.1.2 Applying the measurement objective

The following diagram provides an overview of the measurement of liabilities proposed in the 2010 ED:

3.1.3 Measuring liabilities using the fulfil approach

Expected present value for all obligations

2010 ED, BC5-BC8, BC12-BC18

A key aspect of applying the measurement objective is the model used to measure liabilities. As part of this project the Board has decided to mandate the use of expected present value to measure not only large populations of similar items but also single obligations (e.g. lawsuits). In the 2010 ED the Board is not inviting comments on its decision to mandate the use of expected present value to measure all obligations.

The following diagram provides a high-level comparison between the approaches used to measure liabilities under IAS 37 (current practice) and the proposed model using the fulfil approach:
Observation – significant change to current practice
We expect that the Board’s decision to mandate the use of expected present value to measure single items could result in significant changes to current practice, as in our experience current practice is to measure single obligations at their most likely outcomes. This change is illustrated in the example below:

Observation – applicability of expected present value calculation
It is not clear from the 2010 ED whether an expected present value calculation will be used for all provisions or only those measured under the fulfil approach.

Illustrative example
A customer slips on Company P’s floor and is injured. P accepts that it has a present obligation and is not disputing the claim. P estimates that there is an 80 percent probability of a payment of 100 and a 20 percent probability of a payment of 10; both amounts include associated costs. Ignore the time value of money.

IAS 37
In our experience, practice under IAS 37 is for P to recognise a liability of 100, since this is the most likely outcome and therefore the best estimate of the present value of the expenditure required to settle the obligation.

Anticipated replacement standard
Under the anticipated replacement standard it is expected that P would recognise a liability at its expected present value of 82 ((100 x 80%) + (10 x 20%)) plus a risk adjustment (see step 3 of calculating expected present value under the fulfil approach in 3.1.3 for further information on the risk adjustment).

Calculating expected present value under the fulfil approach
The following diagram illustrates the proposed elements of the expected present value calculation under the fulfil approach:

Probability-weighted expected outflows of resources measured at value
Time value of money (- factor)
Risk adjustment (uncertainty of outflows) (+ factor)

Present value of resources required to fulfil an obligation (expected present value)

2010 ED.B2-B4
Expected present value is the probability-weighted average of the present values of the outflows for the possible outcomes. The proposals in the 2010 ED describe three steps to the expected present value calculation:

Step 1: Identify a reasonable distribution of possible outcomes and estimate the probability of each outcome occurring;
Step 2: Calculate the expected present value of the outflows;

Step 3: Add the risk adjustment.¹

See section 4 for a worked example illustrating the measurement of a liability using the expected present value model.

Step 1: Identify a reasonable distribution of possible outcomes and estimate the probability of each outcome occurring

The amount and/or timing of the outflows of resources required to fulfil an obligation might be uncertain. The 2010 ED suggests that it may not be necessary for an entity to identify all possible outcomes when calculating expected present value. The objective is to identify a sufficient number of outcomes such that they represent a reasonable estimate of the distribution of possible outcomes. The Board believes that this often can be achieved using a limited number of outcomes and probabilities.

There are three elements in step 1:

1. amount of outflows;
2. timing of outflows; and
3. associated probabilities of the outcomes.

There might be different estimates of the amount and/or timing of the outflows. Each combination of an amount and its timing represents a possible outcome. The possible outcomes are assigned their associated probabilities, with the sum of the probabilities being 100 percent.

The outflows in step 1 represent estimates of what the outflows will be when the obligation is fulfilled. For example, if an entity has an obligation to dismantle an oil rig in ten years’ time and there is a market for dismantling services, then the outflows in this step would represent the estimated amount that a contractor would charge in ten years’ time to dismantle the oil rig (see 3.2 for further information on service-related obligations).

Step 2: Calculate the expected present value of the outflows

There are two stages to calculating the expected present value of the outflows:

1. discount each outcome identified in step 1 to its present value; and
2. weight the present values of these outflows by their associated probabilities.

The 2010 ED proposes that the discount rates used to calculate the present values should reflect:

- current market assessments of the time value of money; and
- risks specific to the liability to the extent that those risks are taken into account by adjusting the discount rate rather than by other methods.

Consistent with IAS 37, the 2010 ED proposes that the relevant outflows should be measured before tax. Consistent with this, the discount rate used should be a pre-tax rate.

The 2010 ED does not address whether amounts should be nominal amounts or adjusted for inflation. In practice, the key issue will be taking a consistent approach to inflation in the projection of cash flows and the selection of discount rates. For example, if the outflows are estimated based on future prices, then a nominal discount rate should be used.

¹ In this publication we have characterised the risk adjustment as step 3. However, it may be incorporated into step 1 and/or 2.
Observation – discount rate used

The 2010 ED is silent on credit risk and whether or how it should be reflected in the discount rate. For example, if an entity’s own credit risk is reflected, then two entities with the same obligation but different credit risks would recognise different amounts even if their measurement of the provision was the same in all other respects; the entity with the higher credit risk would recognise a lower provision. Our first impression is that diversity in practice is likely to arise if this issue is not addressed clearly in the final standard.

Step 3: Add the risk adjustment

The risk adjustment is intended to capture the premium that an entity would pay to convert an uncertain amount to a fixed amount. The risk adjustment is likely to be the most challenging aspect of the proposals in the 2010 ED for many entities. The Board members who dissented to the 2010 ED expressed concerns about the risk adjustment as proposed in the 2010 ED.

What is the risk adjustment?

2010 ED.B15

Under an expected present value approach the range of possible outcomes is represented by a single point value. Some possible outcomes with very low probabilities may be amounts that are significantly higher (or lower) than the expected present value. For example, a liability may have an expected present value of 50, with the possible outcomes ranging between 30 and 100. The 2010 ED proposes that a risk adjustment be made for the amount that the entity rationally would pay in excess of the expected present value of the probability-weighted outflows to be relieved of the uncertainty regarding the actual outcome. It reflects the amount that an entity would pay to convert uncertainty about the outflow of resources to certainty.

For example, Company P has an obligation to dismantle an oil rig in ten years’ time. P calculates the expected present value of the obligation at 100 based on a range of estimates between a present value of 70 and a present value of 140. The risk adjustment captures the amount that P rationally would pay to fix its obligation for these future outflows at a present value of 100.

We understand that the risk adjustment is intended to capture a number of things, including the following:

- Uncertainty associated with future amounts. For example, an entity may be calculating today the expected present value of an obligation to dismantle an oil rig in ten years’ time. The outflows used in the expected present value calculation represent the estimated amount that a contractor will charge in ten years’ time.
- The natural risk aversion of many entities. For example, if given the choice between an expected present value of 100 or certainty of 100, many entities would choose certainty of 100, even though this means forfeiting any potential upside (a gain from settlement for less than 100). However, the amount that an entity would be prepared to pay as a risk adjustment will depend on its attitude to risk, which may be impacted by its ability to diversify and/or insure the variability risk.

How is the risk adjustment taken into account in measuring the liability?

2010 ED.B16

The 2010 ED proposes that the risk adjustment can be included by:

- adding it to the expected present value of the probability-weighted cash flows;
- adjusting the discount rate; or
- adjusting the estimates of future outflows.

Therefore, even though in this publication we have characterised the risk adjustment as step 3, it may be incorporated into step 1 and/or 2.
If the risk adjustment is taken into account in the discount rate, then this typically would result in a lower discount rate. This is in order for the risk adjustment to increase the amount of the liability recognised.

**Observation – operationality of the risk adjustment**

The 2010 ED does not provide much guidance on the risk adjustment. In the view of the dissenting Board members, it is not clear what the risk adjustment represents, how it is calculated and when it is included. Our first impression is that the risk adjustment as proposed in the 2010 ED may be difficult or costly for certain entities to operationalise. This may raise questions about whether the benefits of the risk adjustment exceed its cost for certain entities. Also, given the subjectivity involved and the lack of observable market data, there may be concerns about the risk margin reducing comparability or potentially encouraging excess prudence.

**Observation – diversification of risk**

The 2010 ED is silent on how diversification of the risks would affect the risk adjustment; all six Board members who dissented to the 2010 ED disagreed with the 2010 ED remaining silent on this issue.

Our first impression is that the ability to diversify would affect the amount of the risk adjustment. This is because an ability to diversify should affect the amount that an entity rationally would pay to be relieved of the risk that actual outflows differ from the expected present value calculated.

Since the 2010 ED is silent on diversification, it is not clear whether diversification in the market (e.g. whether an entity could get insurance against the uncertainty risk) should affect the amount of the risk adjustment.

Our first impression is that diversity in practice is likely to arise if this issue is not addressed clearly in the final standard.

**Future events – how are they taken into account when measuring liabilities?**

The 2010 ED proposes that when measuring liabilities an entity takes into account future events that might affect the outflow of resources without changing the nature of the obligation. The requirement in IAS 37 is to take into account future events that may affect the outflows when there is sufficient objective evidence that they will occur. Therefore, it appears that there are two differences between IAS 37 and the proposal in the 2010 ED:

- under the proposal in the 2010 ED a future event would be taken into account in measuring a liability before there is sufficient objective evidence that it will occur; the probability of it occurring is factored into the measurement; and
- there is an additional requirement in the 2010 ED that a future event should not change the nature of an obligation in order to be taken into account in its measurement.

**Observation – changing the nature of an obligation**

The 2010 ED does not provide guidance on what is meant by “changing the nature of an obligation”, although it points in the direction of changes in legislation changing the nature of an obligation and changes in technology not changing the nature of an obligation; an explanation of the rationale is not provided. Our first impression is that without further guidance in the final standard, there could be diversity in practice in this area.
Illustrative example
Company P has a present obligation to decontaminate a site in ten years’ time. P’s experience indicates that future advances in technology will reduce the contractor prices for decontaminating sites. In addition, P thinks that it is possible that there may be a change in legislation in the future that would make the decontamination of this site more onerous.

Should P take these future events into account in measuring the liability:

- under IAS 37?
- under the proposed approach?

Change in technology
Under IAS 37 P would take the change in technology into account in measuring the liability when there is sufficient objective evidence that it will occur.

Under the proposed approach P would take the change in technology into account in measuring the liability, as the change in technology would affect the outflows but would not change the nature of the obligation. Different possible outcomes would be identified based on the changes in technology occurring and not occurring and the estimated effect that these possible changes in technology would have on the outflows. Each of these outcomes then would be assigned its associated probability in order to compute the expected present value for this obligation.

Change in legislation
Under IAS 37 P would take the change in legislation into account in measuring the liability when it is virtually certain to be enacted.

Under the proposed approach, whether P takes the change into account when measuring the liability would depend on whether the change in legislation is considered to change the nature of the obligation.
3.2 Proposal 2: Service-related liabilities

**Background to the proposal in the 2010 ED**

When measuring a liability under the fulfil approach, the first step is to determine whether the nature of the obligation is service-related or non-service related. Our understanding of the distinction is as follows:

- If an obligation could be fulfilled by making payments to the counterparty (e.g. lawsuit), then it is a non-service related obligation. Note that the payment of cash should be to the counterparty, not a third party.
- If an obligation will be fulfilled by undertaking a service (e.g. dismantling an oil rig), then it is a service-related obligation. Note that whether the entity intends to fulfil the obligation by undertaking the service itself or engaging third-party contractors is irrelevant for the classification of the obligation as service-related or non-service related.

Both service-related and non-service related obligations would be measured using expected present value. The proposal in the 2010 ED to measure provisions with a profit margin relates to the measurement of service-related obligations only. Non-service related obligations would be measured using expected present value with the relevant outflows being payments to the counterparty and associated costs (e.g. legal costs) without a profit margin.

The following diagram provides an overview of the approach used to measure liabilities under the proposed model when using the fulfil approach:

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### Observation – distinguishing between service-related and non-service related obligations

It is unclear from the 2010 ED whether all obligations that could be fulfilled other than by making payments to the counterparty should be regarded as service-related obligations.

### Proposal in the 2010 ED

The 2010 ED proposes that service-related obligations would be measured by reference to the price that a contractor would charge to undertake the service, i.e. including a profit margin. This is irrespective of the entity’s intentions with regard to settling the obligation, i.e. irrespective of whether the entity intends that the work will be carried out by an in-house team or by external contractors. If a market exists for the service, then the third party contractor’s price would be used. In the absence of a market for the service, the entity would estimate the price that it would charge another party to carry out the service at the future date when the obligation is fulfilled, i.e. the...
costs that the entity expects to incur and the margin that it would require to undertake the service. Our understanding is that current market prices would be used as a basis for estimating future market prices.

This proposal would be a change from current practice for service-related obligations when the entity intends to undertake the service itself. Current practice is for management intention to drive measurement of the liability. If the intention is to perform the work in-house, then the provision is measured based on internal costs to fulfil the obligation, i.e. no profit margin included. If the intention is to engage a third-party contractor to carry out the service, then the provision is measured based on the price that the contractor would charge, i.e. the contractor’s profit margin would be included.

**Observation – profit recognised on fulfilment of obligation if service performed in-house**

The proposal in the 2010 ED to include a profit margin in the measurement of service-related liabilities means that, if an entity intends to, and subsequently does, undertake the service itself, then:

- on initial recognition of the liability, the expense will be higher than the amount that the entity expects to incur to undertake the service; and
- a profit will be recognised as the obligation is fulfilled.

See example below for an illustration of this observation.

The following diagram provides a comparison of the approaches used to measure service-related liabilities under IAS 37 and the proposed model:

![Comparison Diagram](image)

All six Board members who dissented to the 2010 ED disagreed with including a hypothetical profit in the measurement of service-related obligations that the entity intends to satisfy by undertaking the service itself. Their reasons include:

- If an entity intends to fulfil an obligation by undertaking the service itself, then the profit margin is a hypothetical amount that does not represent an actual payment of cash or other outflow of the entity’s resources. The dissenting Board members believe that reducing net profit during the period in which the liability is recognised (assuming that the expense is not capitalised), and increasing net profit during the period in which the liability is fulfilled, creates inappropriate performance information for financial statement users.
The 2010 ED does not provide guidance on what constitutes a market in order to make the determination of whether to use a third-party contractor price or the price that the entity would charge another party to undertake the service.

The 2010 ED does not provide guidance on how to determine the margin that the entity would charge another party in situations in which it is determined that no market exists for the service.

**Observation – which costs to include when measuring a service-related liability**

The Board believes that IAS 37 is not specific in respect of what costs to include in the measurement of a liability and acknowledges that diversity in practice exists in this area. Under the proposals in the 2010 ED costs would be relevant only as a starting point to calculate the price that it would charge another party because a market for the services does not exist. Although not explicitly stated in the 2010 ED, our first impression is that it appears that the calculation of costs would be expected to include all costs, i.e. not just incremental costs but also allocations of fixed costs and charges for owned and leased assets used etc. The rationale is that if the entity was in the business of providing this service, then this is how it would price its service.

**Illustrative example**

Company X, an oil production company, has a present obligation to dismantle an oil rig at the end of the oil rig’s life. X cannot cancel this obligation or transfer it to a third party.

X intends to perform the dismantling activities in-house as it does for all of its oil rigs. X’s best estimate of the cost in ten years’ time to dismantle the oil rig, if it performs the work in-house, is 50; the present value of which is 35. The actual cost of dismantling the rig in ten years’ time is 50.

A market exists for dismantling services as it would be possible for X to hire third-party contractors to perform the work. Assume that there is a 100 percent probability that the external contractor price to dismantle the oil rig in ten years’ time will be 60 (the present value of which is 43), and therefore no risk adjustment is required under the 2010 ED. Assume also that there is a 100 percent probability that the life of the oil rig will be ten years.

How would X account for the obligation:

- under IAS 37?
- under the proposed approach?

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IAS 37

Practice under IAS 37 is for X to recognise a liability of 35, since this is the best estimate of the present value of the expenditure required to settle the obligation. There is no profit or loss impact on settlement of the obligation, apart from adjusting the discounted present value to reflect the time value of money, since the actual cost in Year 10 is 50.

Proposed approach

The liability initially would be recognised at 43, which is the present value of the resources required to fulfil the obligation based on third-party contractor prices including a profit of 10 over what X expects it to cost as this is a service-related obligation. The profit of 10 would be recognised as the obligation is fulfilled, which in this case would be in Year 10. If in this case dismantling were to occur over two years, then the profit would be recognised over two years, as the service to fulfil the obligation is performed over two years.

If a market did not exist for such dismantling, then under the proposed approach X would recognise a liability by estimating the price that it would charge another party to carry out the service, i.e. the costs X would expect to incur and the profit margin it would require to undertake the service for the other entity. Based on the discussion in the 2010 ED, it appears that the calculation of costs would be expected to include not just incremental costs but also allocations of fixed costs and charges for owned and leased assets used.

Note:

This example makes a number of simplifying assumptions in order to isolate the proposal in the 2010 ED to include a profit margin in the measurement of service-related obligations:

- no risk adjustment is required to be added to the liability recognised by assuming that there is a 100 percent probability that the price to dismantle the oil rig in ten years’ time will be 60;
- it is assumed that there is a 100 percent probability that the life of the oil rig will be ten years; and
- it is assumed that there are no adjustments to the carrying amount of the liability between its initial recognition and its fulfilment, other than in respect of the unwinding of the discount and settlement of the obligation.

See section 4 for a worked example in which these simplifying assumptions are not made.
3.3 Proposal 3: Limited exception for onerous sales and insurance contracts

An onerous contract is one in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under the contract. We understand that the Board's objective in the 2010 ED is to propose a limited exception to the proposed measurement requirements for obligations for:

- onerous sales contracts arising from transactions within the scope of IAS 18; and
- onerous insurance contracts arising from transactions within the scope of IFRS 4, which are measured in accordance with IAS 37.

We understand that the IASB's objective with this proposed exception is to avoid changing current practice for the measurement of onerous contract obligations arising from transactions within the scope of IAS 18 or IFRS 4. The rationale behind the proposed exception is to postpone any changes in practice until the Board completes its ongoing projects to replace current IAS 18 and IFRS 4. The accounting for onerous sales and insurance contracts is being considered as part of those projects. Therefore the Board wants to avoid any change in practice now that might need to be changed again when the replacement revenue and insurance standards are issued. The Board intends to revisit this proposed exception when it issues the new standards to replace current IAS 18 and IFRS 4. At that time the exception would be either confirmed or deleted.

Insurance contract liabilities are within the scope of IFRS 4, which permits entities using IFRSs to continue using previous accounting policies for insurance contract liabilities, subject to certain limits. If the interim accounting policies that an entity is using for insurance policy liabilities do not require a liability adequacy test that meets the minimum requirements outlined in IFRS 4, then they are measured in accordance with IAS 37 to assess whether the insurance liability is adequate at the reporting date. The proposed exception in the 2010 ED relates to these insurance contracts.

Observation – drafting of proposed exception

While we understand that the IASB's objective with this proposed exception is to avoid changing current practice for the measurement of onerous sales and insurance contracts, our first impression is that the drafting of the proposed exception in the 2010 ED does not achieve the Board's objective. For example:

- The drafting of the proposed exception could be read as though the exception is for service-related onerous sales and insurance contracts only, with non-service related ones remaining within the scope of the measurement requirements of the 2010 ED.
- The 2010 ED proposes that onerous sales and insurance contracts that are the subject of the exception would be measured at "the costs the entity expects to incur to fulfil its contractual obligations". Given that there currently is diversity in practice in the measurement of onerous contracts, such a prescribed measurement requirement may result in a change to current practice for some entities.
- The scope of the proposed exception does not include items currently within the scope of IAS 37 that are expected to be within the scope of the replacement revenue standard upon completion of that project, e.g. certain warranties. Therefore, this could result in a change in practice for those items now, with a possible additional change in practice when the new revenue standard is issued.

2 For further information on accounting for onerous contracts, see Insights into IFRS 3.12.630.
3 For further information on the IASB’s ongoing projects to replace current IAS 18 and IFRS 4, see IFRS Briefing Sheet Issue 175 and IFRS – Insurance Newsletter.
4. Worked example

This example is based on the illustrative example provided in the 2010 ED.

Fact pattern

Company Y, an oil production company, has a present obligation to dismantle an oil rig at the end of
the oil rig’s life. Y cannot cancel this obligation or transfer it to a third party.

Y intends to perform the dismantling activities in-house as it does for all of its oil rigs. Y’s best
estimate of the present value of the cost to dismantle the oil rig if it performs the work in-house,
is 100.

A market exists for dismantling services so it would be possible for Y to hire third party contractors
to perform the work. The current external contractor price to dismantle the oil rig today would be
125 based on existing legal requirements.

Assume that there are no adjustments to the estimates of the amounts and timing of outflows and
their associated probabilities between the initial recognition of the liability and its fulfilment.

This worked example illustrates the amount that Y would recognise as a liability:

- under IAS 37; and
- under the proposed approach.

IAS 37

Practice under IAS 37 is for Y to recognise a liability of 100, since this is the best estimate of the
present value of the expenditure required to settle the obligation.

Proposed approach

The obligation is measured using the fulfil approach, since it cannot be cancelled or transferred to
a third party. Therefore it is measured at the present value of the resources required to fulfil the
obligation using expected present values.

Step 1: Identify a reasonable distribution of possible outcomes and estimate the probability of each
outcome occurring

<table>
<thead>
<tr>
<th>Outcome</th>
<th>Useful life of rig</th>
<th>Estimated contractor price</th>
<th>Estimated probability</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>10 years</td>
<td>200</td>
<td>5%</td>
</tr>
<tr>
<td>2</td>
<td>10 years</td>
<td>225</td>
<td>25%</td>
</tr>
<tr>
<td>3</td>
<td>10 years</td>
<td>275</td>
<td>20%</td>
</tr>
<tr>
<td>4</td>
<td>15 years</td>
<td>230</td>
<td>5%</td>
</tr>
<tr>
<td>5</td>
<td>15 years</td>
<td>260</td>
<td>25%</td>
</tr>
<tr>
<td>6</td>
<td>15 years</td>
<td>340</td>
<td>20%</td>
</tr>
</tbody>
</table>

Y is not required to identify all possible outcomes. Its objective should be to identify a sufficient
number of outcomes such that they represent a reasonable estimate of the distribution of possible
outcomes. The 2010 ED notes that this often can be achieved using a limited number of discrete
outcomes and probabilities.
The outflows represent estimates of what a contractor would charge in 10 or 15 years time to dismantle the oil rig. In this case the obligation is service-related and therefore would include a profit margin for the services to be performed. Since a market exists for the services, the liability is measured using market prices from a third-party contractor; these prices are assumed to include a profit margin so no additional profit margin adjustment is made. In this case current market prices are used as a basis for estimating future market prices.

**Step 2: Calculate the expected present value of the outflows**

There are two parts to this step. Firstly Y discounts the outflows to their present values; then Y weights the present values of the outflows based on their associated probabilities.

<table>
<thead>
<tr>
<th>Outcome</th>
<th>Estimated contractor price</th>
<th>Discount rate</th>
<th>PV of outflow</th>
<th>Estimated probability</th>
<th>PV x Probability</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>200</td>
<td>6%</td>
<td>112</td>
<td>5%</td>
<td>6</td>
</tr>
<tr>
<td>2</td>
<td>225</td>
<td>6%</td>
<td>126</td>
<td>25%</td>
<td>31</td>
</tr>
<tr>
<td>3</td>
<td>275</td>
<td>6%</td>
<td>154</td>
<td>20%</td>
<td>31</td>
</tr>
<tr>
<td>4</td>
<td>230</td>
<td>5.5%</td>
<td>103</td>
<td>5%</td>
<td>5</td>
</tr>
<tr>
<td>5</td>
<td>260</td>
<td>5.5%</td>
<td>116</td>
<td>25%</td>
<td>29</td>
</tr>
<tr>
<td>6</td>
<td>340</td>
<td>5.5%</td>
<td>152</td>
<td>20%</td>
<td>30</td>
</tr>
</tbody>
</table>

**Expected present value of outflows**

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>132</td>
</tr>
</tbody>
</table>

The 2010 ED is silent on how credit risk should be reflected in the discount rate. In the example in the 2010 ED the cash flows are discounted using the risk-free rate, since the risk adjustment is taken into account by adding it to the expected present value of the probability-weighted cash flows (see step 3).

The discount rate used for outcomes 1 to 3 is different from the discount rate used for outcomes 4 to 6 because outcomes 1 to 3 are based on the useful life of the oil rig being ten years whereas outcomes 4 to 6 are based on a useful life of 15 years.

The discount rate used should be consistent with how inflation is considered in determining the cash flows, i.e. nominal vs inflation adjusted cash flows (see 3.2).

**Step 3: Add the risk adjustment**

Based on the facts and circumstances Y estimates that it would pay 7 to be relieved of the risk that actual outflows would differ from the expected present value of 132.

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Expected present value of outflows</td>
<td>132</td>
</tr>
<tr>
<td>Risk adjustment (5%)</td>
<td>7</td>
</tr>
<tr>
<td><strong>Liability recognised</strong></td>
<td><strong>139</strong></td>
</tr>
</tbody>
</table>

The illustrative example provided in the 2010 ED indicates that in determining the 5 percent risk margin in that example, management made a subjective judgement of how much extra it rationally would pay to be relieved of the additional risk that arises from the uncertainty over how the price that it would have to pay will change between now and the end of the rig’s useful life and from the uncertainty about when the rig will reach the end of its useful life. As the time periods involved increase (e.g. 15 vs 10 years), this uncertainty also would increase.
The commentary in the 2010 ED example implies that the risk margin is a subjective amount, which takes into account the entity’s own attitude to risk. Although not mentioned in the 2010 ED, other factors that management might have taken into account when making such an assessment could include:

- whether a market exists for the risk that actual outflows will differ from the expected present value, i.e. could Y purchase insurance against that risk; and
- the degree of variance in outcomes. For example, we would expect the obligation for the dismantling of an oil rig with a distribution of outcomes between 49 and 51 to have a different risk adjustment to the dismantling of an oil rig with a distribution of outcomes between 10 and 100, even if both obligations otherwise have the same expected present value.

See 3.1.3 for further information on the risk adjustment.

Notes:
Timing of recognition of profit:
Y intends to perform the dismantling work in-house but the liability is measured by reference to the price a third-party contractor would charge Y to perform the work. Therefore the liability is likely to include a profit margin over what Y expects it to cost to perform the work. Ignoring the unwinding of the time value of money and any changes to the risk adjustment, if it ends up costing Y 100 to settle the liability, then under the proposed approach Y would recognise a profit for the difference between costs incurred and the reduction in the liability as the obligation is fulfilled. In the example, this profit of 39 (139 - 100) would be reflected in profit or loss as the obligation is fulfilled, e.g. if dismantling is performed evenly over two years, then the profit would be recognised over two years.

In a real-life case it is unlikely that the estimated cost would remain unchanged as the dismantling date approaches, as generally uncertainty decreases as the period of time until the obligation is required to be fulfilled decreases. For example, uncertainty about whether the rig would be dismantled in 10 or 15 years would be resolved.

If a market did not exist for the dismantling service:
If a market did not exist for services to dismantle oil rigs, then under the proposed approach Y would recognise a liability by estimating the price that it would charge another party to carry out the service, i.e. the costs that Y would expect to incur (100) plus the profit margin that it would require to undertake the service for the other entity. Based on the discussion in the 2010 ED, it appears that the calculation of costs would be expected to include not just incremental costs but also allocations of fixed costs and charges for owned and leased assets used.
5. **Anticipated changes not re-exposed in the 2010 ED**

There are a number of significant changes to current practice expected in the area of provisions that are not being re-exposed as part of the 2010 ED. These changes include:

- requiring single obligations to be measured using expected present value;
- removing the current probable outflow of resources recognition criterion for provisions; and
- removing the current “asset cap” on reimbursement right assets.

The Board also identifies a significant change in recognising the costs arising from a restructuring only when the definition of a liability is met. However, it is not clear how this will differ from IAS 37.

The Board is not inviting comments on these aspects of the liabilities project.

5.1 **Single obligations to be measured using expected present value**

As part of this project the Board has decided to mandate the use of expected present value to measure not only large populations of similar items but also single obligations (e.g. lawsuits). This would represent a significant change to current practice as current practice is to measure single obligations at their most likely outcome. The Board is not inviting comments on this in the 2010 ED (see 3.1 for further information).

5.2 **Probability recognition criteria for provisions to be removed**

Under IAS 37 a provision is recognised when: (1) there is a present obligation as a result of a past event; (2) there is a probable outflow of resources required to settle the obligation; and (3) the amount of the obligation can be estimated reliably. It is anticipated that in the replacement standard the recognition criterion of probable outflows (2) above) will be removed. Therefore, a liability would be recognised when: (1) there is a present obligation as a result of a past event; and (2) the amount of the obligation can be estimated reliably. This is irrespective of the probability of outflows, e.g. even if there is only a ten percent probability of outflows, then a liability would be recognised if there is a present obligation and it can be measured reliably. The probability of outflows would be factored into the measurement of the liability.

The logic is consistent with the treatment of contingent liabilities assumed in a business combination required by IFRS 3 *Business Combinations* (2008), which are recognised if there is a present obligation, irrespective of the probability of outflows. In a typical business combination the existence of the obligation usually is evident from the contractual agreement. In many scenarios potentially subject to IAS 37, such as litigation claims, the evaluation as to whether there is a present obligation is more challenging.

Under IAS 37 when there is uncertainty about the existence of a present obligation, an entity considers the facts and circumstances and if it is “more likely than not” that there is a present obligation, then the determination is that there is a present obligation. In addition to removing the probable outflows recognition criterion, we understand that the current intention of the Board is to remove this specific more likely than not guidance for determining whether there is a present obligation in situations of uncertainty and to replace it with additional guidance on determining whether there is a present obligation. It is not yet clear what, if any, impact this will have on practice.
Observation
Our first impression is that we expect this anticipated change to have a number of implications on current practice, including:

- **More present obligations required to be recognised as liabilities:** Currently, if there is a present obligation for which future outflows are not probable, then no provision is recognised. If the probability threshold is removed, then a liability would be required to be recognised in such instances. This may occur, for example, in connection with valid claims that are not expected to be asserted.

- **Increased importance of determining whether there is a present obligation:** If the probability of outflows recognition criterion is removed, then we expect that in practice there would be more pressure on the determination of whether there is a present obligation. Our experience of current practice is that entities often focus on the probability of outflows when determining whether to recognise a provision rather than determining whether they have a present obligation. We expect that determining what the “past event” is that creates a present obligation will be difficult to resolve, at least initially.

Illustrative example
Customer C slips on Company P’s floor and is injured. P accepts that it has a present obligation but believes that there is a 90 percent probability that C will not sue based on C’s actions since the accident. In the event that C does sue, P estimates that there is a 70 percent probability of a payment of 100 and a 30 percent probability of a payment of 50; both amounts include associated costs. Ignore the time value of money.

**IAS 37**
Practice under IAS 37 is that P would not recognise a provision, since an outflow of resources is not probable. P would regard this as a contingent liability and consider whether disclosure of this contingent liability would be required.

**Anticipated replacement standard**
Under the anticipated replacement standard it is expected that P would recognise a liability at its expected present value of 8.5 (10% x ((100 x 70%) + (50 x 30%))) plus a risk adjustment (see 3.1 for further information on the risk adjustment).

Illustrative example
Customer B claims to have slipped and injured himself on Company P’s floor. P is disputing the claim. In this case there is uncertainty about whether or not P has a present obligation because it is not clear whether the customer was injured as a result of slipping on P’s floor and, if he was, then whether P was liable.

**IAS 37**
Practice under IAS 37 is for P to recognise a provision if: (i) it is more likely than not that P has a present obligation; (ii) an outflow of resources is probable; and (iii) the amount of the obligation can be measured reliably. If a provision is recognised, then it is measured at the best estimate of the present value of the expenditure required to settle the obligation, i.e. most likely outcome.

**Anticipated replacement standard**
Under the anticipated replacement standard it is expected that P would use its judgement to determine whether it has a present obligation, taking into account all available evidence and giving more weight to the evidence that is more persuasive. P would recognise a liability if it has a present obligation and the amount of the liability can be estimated reliably. If a liability
is recognised, then it would be measured at its expected present value plus a risk adjustment (see 3.1 for further information on the risk adjustment).

5.3 “Asset cap” on reimbursements to be removed

Under IAS 37 there is an “asset cap”, which limits the amount recognised for a reimbursement right asset to the corresponding provision amount. It is anticipated that in the replacement standard this asset cap will be removed.

**Illustrative example**

Company P has recognised a provision of 100. P is virtually certain that it will receive a reimbursement of 150 in respect of the provision when it settles the obligation. Ignoring the time value of money, how much should P recognise as a reimbursement right asset:

- under IAS 37?
- under the anticipated replacement standard?

**IAS 37**

Under IAS 37 P would recognise a reimbursement right asset of 100.

**Anticipated replacement standard**

Under the anticipated replacement standard P would recognise a reimbursement right asset of 150.

5.4 Restructuring provisions

Under IAS 37 a restructuring provision is recognised when: (i) there is a present obligation as a result of a past event; (ii) there is a probable outflow of resources required to settle the obligation; and (iii) the amount of the obligation can be estimated reliably. When there is a constructive obligation for a restructuring (i.e. a detailed formal plan for the restructuring and a valid expectation raised in those affected that the restructuring will be carried out), a restructuring provision is recognised under IAS 37 for all restructuring costs other than redundancy payments, pension plan changes and the impairment of assets. Measurement of these other items would be considered separately in accordance with the requirements of IAS 19 *Employee Benefits* and IAS 36 *Impairment of Assets*, respectively.

It is anticipated that in the replacement standard, each component of a restructuring plan would be recognised as a liability only when the definition of a liability is met in respect of that component. This is in contrast to the IAS 37 approach of considering the costs associated with the plan as a whole, i.e. there would not be a single *restructuring* provision under the replacement standard. This would align the recognition criteria for recognising costs arising from a restructuring with other liabilities under the replacement standard. It is not yet clear what implications this change will have in practice.
6. Project timeline

The IASB has invited comments on the proposals contained in the 2010 ED by 19 May 2010. Comments are invited on only the specific proposals contained in the 2010 ED and not on any other aspects of the liabilities project.

The IASB published a working draft of the replacement standard on its website on 19 February 2010; however, this is only for the information of constituents and the Board has not invited comments on it.

The replacement standard currently is scheduled to be published in the fourth quarter of 2010.
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