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Straight away

IFRS bulletin from PricewaterhouseCoopers

IASB proposes significantly different measurement model for non-financial liabilities

What is the issue?

The IASB has exposed revised proposals to amend the measurement of non-financial liabilities (formerly provisions) under IAS 37, 'Provisions, contingent liabilities and contingent assets'. The revised proposals would affect the measurement of most provisions and will be relevant to almost every entity. The initial proposals were originally issued in 2005 and the remainder of the amendments exposed at that time are not expected to change significantly.

A new IFRS to replace IAS 37 is expected to be published in the third quarter of 2010.

New measurement guidance

Provisions will be measured at the present value of the amount that an entity would rationally pay to be relieved of an obligation at the balance sheet date. This is a measure of the value and not of the expected cost to the entity. It is expressed in the exposure draft as the "lowest of;

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

When the amount of resources required to fulfil the obligation is uncertain, the provision will be measured using the weighted average of all possible outcomes ("expected value"). This will rarely be the amount eventually paid, but will reflect the uncertainty inherent in the estimate. The provision will be discounted using a rate that reflects the time value of money and any risks specific to the obligation that are not reflected in the expected value calculation.

It is seldom possible to cancel an obligation or transfer the liability to a third party at a lower amount than the value of the resources required to fulfil the obligation, so provisions will often be measured at this value. When the obligation is to pay cash, for example to settle litigation, it will be measured at the expected cash payment plus any associated costs.

When the obligation is to deliver a service, for example a warranty or an asset decommissioning obligation, it will be measured at the amount that would be paid to a contractor to undertake the service, based on the market price for the relevant service. When there is no market price for the service, the amount that would be paid to a contractor will be estimated, and this estimate will include the direct and indirect costs and margin that would be recovered by a contractor undertaking the service.

The proposed guidance is different to the way provisions are often measured today. Many provisions are measured using management's best estimate of the amount that will be paid, rather than expected value, and provisions could be higher or lower when a weighted average probability is used. Most provisions for an obligation to deliver a service are measured under the existing standard at the expected cost of fulfilling the obligation rather than the value of the resources required. There is some diversity in practice in the extent to which indirect costs are included, and the margin that would be charged by a contractor is rarely added. The revised proposals are therefore likely to result in some provisions being higher than the amount currently recorded.

For example, management might currently record a provision for decommissioning an asset as the direct costs of the labour and materials required. The revised proposals would require the provision to include the recovery of direct and indirect overhead costs and the margin that would be charged by a third party contractor. There is a limited exception to the proposals. The proposed measurement guidance will not apply to onerous contracts arising from transactions in the scope of IAS 18 and IFRS 4 pending completions of the IASB's revenue and insurance projects.

Am I affected?

The revised proposals are likely to apply to most entities and the impact could be significant, particularly for entities that currently record significant provisions, for example in connection with environmental restoration or asset decommissioning.

What do I need to do?

The comment period will close on 12 April 2010. The proposed changes are significant; management should first consider whether to comment on the IASB's proposals. Management should also begin to consider how the proposals would affect the measurement of existing liabilities and whether it would be necessary to collect additional information.

A working draft of the standard that will replace IAS 37 will be published on the IASB website in February. This working draft will reflect a number of other changes to the existing model, including the removal of the requirement that an outflow of resources be probable for a liability to be recorded. Management should also begin to consider this and other changes to the recognition of provisions and the implications for the financial statements.