ASC
ACCOUNTING STANDARDS COUNCIL

23 April 2010

International Accounting Standards Board
1st Floor 30 Cannon Street
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United Kingdom

(By online submission)

Dear Sir

RESPONSE TO EXPOSURE DRAFT ON MEASUREMENT OF LIABILITIES IN IAS 37

The Accounting Standards Council (ASC) appreciates the opportunity to comment on the Exposure Draft on Measurement of Liabilities in IAS 37 issued by the International Accounting Standards Board (the IASB or the Board) in January 2010.

Whilst we understand that the IASB is keen on completing the liabilities project as it has been outstanding for many years and has decided not to invite comments on various aspects of the proposed changes to IAS 37, our comments below are not limited to the questions in the ED so as to offer a more coherent view.

General comments

Due process

The Board has carved out and re-exposed only selected parts of the section of the new IFRS dealing with the measurement of liabilities in this ED. We do not support this limited re-exposure and believe that the entire proposed standard should be re-exposed in view of the significant time lag since the original ED was issued. In addition, the original ED introduces fundamental changes to the recognition and measurement of liabilities which raised many unaddressed concerns among constituents. Furthermore, we believe that it may not be appropriate to consider measurement requirements in isolation, given measurement and recognition are interlinked.

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Abolishment of the probability of outflows recognition criterion

We understand that the Board has re-affirmed its proposal in the original ED to remove the probability of outflows recognition criterion. We do not agree with the Board's decision as we believe it creates inconsistencies with paragraphs 50[1], 83[2] and 91[3] of the current Framework. We urge the Board to be mindful that making fundamental changes through a standard rather than the Conceptual Framework project could potentially undermine the authority of the Framework. In addition, it increases the likelihood of future changes to the proposed standard as a result of subsequent deliberations of the Framework.

The removal of the probability recognition criterion would also result in the recognition of liabilities that have a low possibility of a future outflow of resources. In our opinion, the recognition of a liability for an obligation that is not expected to occur is not desirable and does not reflect the economic reality of the situation. It creates artificial volatility and undermines the relevance of financial statements, as entities would recognise a present obligation with a low probability of outflow in one period only to reverse it in another period. We believe that users of financial statements are interested in probable consumption of resources (i.e. expected outflow of resources), rather than financial information which does not help in predicting an entity's capacity to generate cash flows in the future.

Moreover, entities are likely to grapple with whether or not a past event has occurred and whether or not there is in fact an unconditional obligation, particularly in the case of legal disputes and claims. We believe that there is a genuine risk that entities will continue to rely on their assessment of the probability of outflows to help them determine whether they are liable (i.e. based on the current IAS 37 approach), as there is a strong correlation between a judgement that an outflow is probable and a judgement that an entity is liable. In addition, entities are likely to be under pressure not to recognise liabilities with low probability of outflow as to do so would be tantamount to an admission of guilt. In this regard, we recommend that the Board provides further application guidance through the life cycle of a legal dispute/claim should the Board decide to proceed with the proposed recognition requirements, as the guidance in paragraphs 14 and 15 of the Working Draft on Liabilities would not make it any easier for entities to conclude whether they have an obligation.

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[1] The definitions of an asset and a liability identify their essential features but do not attempt to specify the criteria that need to be met before they are recognised in the balance sheet. Thus, the definitions embrace items that are not recognised as assets or liabilities in the balance sheet because they do not satisfy the criteria for recognition discussed in paragraphs 82 to 98. In particular, the expectation that future economic benefits will flow to or from an entity must be **<u>sufficiently certain</u>** to meet the probability criterion in paragraph 83 before an asset or liability is recognised.

[2] An item that meets the definition of an element should be recognised if (a) it is **<u>probable</u>** that any future economic benefit associated with the item will flow to or from the entity and (b) the item has a cost or value that can be measured with reliability.

[3] A liability is recognised in the balance sheet when it is **<u>probable</u>** that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably.

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Global convergence

We note that there are several areas where there are differences between IFRS and US GAAP (e.g. accounting for liabilities arising from legal disputes). Although we understand the liabilities project is not an MoU or joint project between IASB and FASB, we strongly recommend that the Board work closely with FASB to align the standards, so as to move a step closer to global harmonisation of accounting standards.

Our comments on the specific questions to the ED are as follows:

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?

We have the following concerns with regard to the proposed measurement requirements:

'Lowest of' measurement approach

The ED proposes to measure liabilities at the ***lowest*** of the present value of the resources required to fulfil the obligation and the amounts to cancel or transfer the obligation.

Although we can understand the Board's rationale that an entity is most likely to settle at the lowest amount, we believe that this assumption may be too restrictive, simplistic or prescriptive and does not always reflect economic reality. In our view, entities may choose to settle at a higher outflow for various valid business/commercial reasons (e.g. to protect proprietary information). Applying the 'lowest of' measurement approach would understate liabilities until such time the obligations are satisfied. Hence, we would like to recommend that the commercial feasibility of the settlement options be considered in measuring the obligations, i.e. if an entity cannot discharge its obligation with a lower settlement option for any commercial reasons, the obligation should not be measured at this lower settlement amount.

Expected value model for all liabilities

We understand that the Board has decided to mandate the use of expected value for the measurement of all liabilities, including single obligations.

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Whilst we agree that the use of a statistical method based on possible outcomes and probabilities typically works well for large homogeneous populations, we do not think that it is generally reliable for single obligations as there is often no or insufficient historical outflow data. The lack of history is a fundamental hurdle to the concept of reliability, as the weighing of possible outcomes requires a history to estimate associated probabilities. In our view, introducing the expected value approach for single obligations would significantly increase the complexity, subjectivity and uncertainty of measurement, particularly if the liabilities involved are unique or are of an unprecedented nature. Measurement in such cases would become highly subjective and would be influenced by each entity's interpretation of the facts. Accordingly, we believe that measuring single obligations on this basis could gravely undermine the reliability and credibility of financial statements.

Further, for single obligations, the use of an expected value approach is likely to result in measurement at an amount that bears little resemblance to the actual outflows, which the Board recognises. It would lead to the inclusion in financial statements of amounts that, arguably, will be of very limited informational value. We think that such a measurement approach would reduce the understandability and relevance of financial statements, in addition to creating artificial volatility.

Moreover, to implement this approach, entities would be required to obtain, monitor and update large volumes of data on possible outcomes and associated probabilities. Even if this can be achieved, we believe that it is likely to result in costs that many will find prohibitive.

Hence, we suggest that the Board considers retaining the current requirements of IAS 37 which allow single obligations to be measured at their most likely outcome, particularly in high impact/low probability binary outcome scenarios.

Should the Board decide not to change the proposed measurement approach, we recommend that the Board clarifies whether scenarios of positive outcomes (e.g. counter-claims made by the defendant in a litigation) should be set-off against scenarios of negative outcomes in calculating expected value, and if not, how should such situations be dealt with.

<u>Risk adjustment</u>

We do not support the requirement to include a risk adjustment in estimating the present value of resources required to fulfil an obligation. Although we agree that a risk premium is likely to be included in the amount that an entity would have to pay to transfer the obligation to a third party, we share the concerns expressed by the dissenting IASB members in AV5 that it is not clear what this adjustment is intended to represent if the entity chooses to fulfil the obligation. In our view, if an entity makes an unbiased assessment of the amount, timing and probability of each possible outcome as stipulated in the ED, we do not quite comprehend why an additional adjustment for risk is required.

If the Board decides not to change the measurement guidance, we suggest that the Board clarifies the rationale for including the risk adjustment. The Board should also provide detailed guidance on how to determine such an adjustment as we observe that this is currently missing from the ED.

Additionally, we note that B15 of the ED does not always require the inclusion of a risk adjustment and B16 of the ED stipulates that the most appropriate method of including a risk adjustment depends on the nature of the risk and the pattern of the estimated future outflows. However, the ED does not provide guidance on the circumstances in which a risk adjustment is/is not required nor how the most appropriate method should be determined. We recommend that detailed guidance be provided by the Board to avoid significant diversity in practice which could compromise the comparability of financial statements.

Extremely rare cases where reliable measure not available

We note that the ED does not provide any guidance explaining the circumstances in which the reliable measurement criterion will not be satisfied and would like to recommend that the Board provides more clarity on such situations to avert diversity in practice.

Entity's own credit risk

We note that the ED is silent on whether an entity's own credit risk should be incorporated in the measurement of liabilities within the scope of IAS 37. We are of the view that it should not (refer to our comment letter on the Discussion Paper on Credit Risk in Liability Measurement submitted to the IASB on 1 September 2009) and would like to propose that this be clearly affirmed in the final standard to avoid confusion and diversity in practice.

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?

We do not agree with the proposal that obligations to be fulfilled by undertaking a service be measured by reference to the price that a contractor would charge to undertake the service, or the amount that an entity would charge another party to undertake the service in the absence of a market (i.e. including a profit margin).

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We believe that such obligations should be measured at the ***costs*** that an entity expects to incur to fulfil its obligations. In most instances, this would be the price that the entity must pay a contractor to undertake the service. However, if the entity expects to undertake the service itself, the amount should be the costs, rather than the value, of internal resources to be used to fulfil the obligation. In this regard, we share the concerns expressed by the dissenting IASB members in AV2(b) that including a profit margin in measuring service-related obligations to be performed in-house would result in the recognition of a hypothetical amount that does not represent a payment of cash or an actual outflow of an entity's resources.

Whilst we appreciate the Board's effort to reduce subjectivity in measurement and diversity in practice, we do not agree that similar liabilities should be measured at similar amounts by different entities irrespective of the extent to which the entities will employ internal resources rather than contractors to fulfil the obligations. We are not convinced that this would provide better and more decision-useful financial information. We are of the view that management's intention (i.e. whether the obligation will be performed in-house or by external contractor) should continue to drive the measurement of liabilities.

We also disagree with BC21(e) that an entity should attribute the profit it earns to all of its activities that are necessary for it to generate revenue and create value for the capital providers. Following this argument, a profit could be recorded by an entity when it undertakes activities to, say, self-construct its property, plant and equipment (PPE). We do not think that this is appropriate and it is also not consistent with the requirements in IAS 16. Furthermore, if an entity recognises an impairment loss on its PPE, it seems counter-intuitive to recognise a profit when the entity decommissions the PPE.

Finally, we note that the ED does not provide any guidance on what constitutes a market and how a margin should be determined in the absence of a market for the service. We agree with the views of the dissenting IASB members in AV2(c) that the lack of guidance may lead to significant variations in the margins that different entities include for similar obligations and could provide a means of earnings management. Accordingly, we recommend that the Board clarifies what constitutes a market and provides detailed guidance on how a margin should be determined in the absence of such a market.

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?

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We concur with the proposal as it is consistent with our view in Question 2 that costs, rather than value, be used in the measurement of obligations to undertake a service. However, rather than introducing this measurement approach as a temporary limited exception, we would like to recommend that the IASB extend it to all obligations which will be fulfilled by undertaking a service at a future date.

We hope that our comments will contribute to the IASB's deliberation on this exposure draft. Should you require any further clarification, do contact me. Thank you.

Yours faithfully

Dexter Tan
Secretary, Accounting Standards Council