19 May 2010

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Your ref: ED/2010/1

Ms Joan Brown
Project Manager
International Accounting Standards Board
30 Cannon Street
London
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Dear Ms Brown

MEASUREMENT OF LIABILITIES

The ICAEW is pleased to respond to your request for comments on *Measurement of Liabilities in IAS 37*.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

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MEASUREMENT OF LIABILITIES IN IAS 37

Memorandum of comment submitted in May 2010 by the ICAEW, in response to the International Accounting Standards Board exposure draft *Measurement of Liabilities in IAS 37*, published in January 2010

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INTRODUCTION

1. The ICAEW welcomes the opportunity to comment on the exposure draft *Measurement of Liabilities in IAS 37*, published by the International Accounting Standards Board.

WHO WE ARE

2. The ICAEW operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, we provide leadership and practical support to over 134,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. We are a founding member of the Global Accounting Alliance, which has over 775,000 members worldwide.

3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. We ensure these skills are constantly developed, recognised and valued.

MAJOR POINTS

Due process

4. We do not believe that the limited scope of the issues on which comments are invited meets the standards for due process that we would expect from the IASB.

5. The ED invites comments on only a relatively narrow range of questions. Yet the ED forms part of a broader proposed reform of IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, following an earlier exposure draft published by the IASB in June 2005. In recognition of this, on 19 February 2010 the Board made available a working draft of the proposed successor standard to IAS 37, IFRS [x], *Liabilities*. We agree with the Board that it is necessary to consider the questions raised in the ED in the context of the proposals for the full standard. However, the working draft does not include:

   - the Basis for Conclusions section of the proposed IFRS; or
   - the illustrative examples that are intended to accompany the proposed IFRS.

   These omissions are significant because they are essential to a proper understanding of the current proposals (see in particular paragraphs 8-10 below).

6. The June 2005 proposals were highly controversial and responses to them were not supportive. Also, the length of time that it has taken the Board to progress matters to the point now reached indicates the difficulty of the issues involved. The Board is of course entitled to disagree with the responses it receives and to proceed without the support of its constituents on any given subject. But on an issue as fundamental as the measurement of liabilities it is appropriate not only for the Board to explain publicly why it has rejected commentators' views but also to see how far commentators find its reasons persuasive. The right course of action would therefore have been to re-expose the Board's full proposals, with the Basis of Conclusions and illustrative examples, and to invite comments on them in their entirety. We believe that the Board should have done this and that the current approach – a request for comments on a limited range of issues on the basis of incomplete information – is unsatisfactory.

7. We do not accept that it is sensible to isolate the questions posed in the ED from the question of the desirability of the Board's overall approach to liabilities and our comments below reflect this. We expect the debate on the Board's proposals to continue, and we

may therefore wish to return to them in due course as more information emerges about the Board's intended approach.

8. The recognition and measurement of liabilities frequently involve difficult judgements. For this reason, it is especially important to have clarity in the requirements that will govern these judgements. Unfortunately, too often the ED's proposals – and those in the working draft standard – are unclear and difficult to understand. We refer to several instances of this below.

9. Some confusion still persists. In a webcast on the ED, the IASB has given an instance of a potential liability for a legal claim where the probabilities are: 70% likelihood of an outcome requiring a payment of zero; 30% likelihood of an outcome requiring a payment of £1m. Our interpretation of the ED is that the required provision in this case would be £0.3m. But in the webcast the IASB representatives say that the liability would be zero, apparently on the grounds that as a zero outcome is more than 50% likely, no liability exists. This logic seems to reintroduce the probability of an outflow of resources criterion and to be contrary to paragraph 22 of the working draft standard. If this is indeed how the ED should be interpreted, the point needs to be made more clearly. In this submission, we assume that what the ED intends is that a provision of £0.3m would be required, and we believe that this is how most people will interpret the proposals, with which we disagree, as they currently stand.

10. This is a good example of how it is difficult to understand the proposals without the benefit of the full Basis for Conclusions or the illustrative examples that will accompany the proposed standard. We have noted the IASB Staff Paper, *Liabilities – IFRS to Replace IAS 37: Recognising Liabilities Arising from Lawsuits*, issued on 7 April 2010. This perhaps makes clearer the logic of the advice given in the webcast referred to above. However, the paper is 'not an official pronouncement of the IASB', and issuing staff papers on the IASB website during an ED's comment period is not a satisfactory way to deal with uncertainties in the ED. The need to issue the staff paper reinforces the point that the ED should have been clearer in the first place, which we would have expected given the amount of time it has taken to get to this stage, and that a full Basis for Conclusions and the illustrative examples should have been supplied. We hope that the guidance in the staff paper will be embodied in due course in either the Basis for Conclusions or the illustrative examples of the proposed new standard.

Definition of a liability

11. We believe that the approach adopted in the ED entails a significant redefinition of what constitutes a liability. The present definition not only underlies the approach in IAS 37 but, more fundamentally, appears in the IASB's conceptual framework, the *Framework for the Preparation and Presentation of Financial Statements*. This states that 'A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits' (paragraph 49(b)). On our understanding (though see paragraph 9 above), the approach in the ED would result in the recognition of liabilities even where an outflow of resources is not expected, ie, when the probability of an outflow is less than 50%. We believe that this is the most natural reading of paragraph 22 of the working draft standard, which states that 'obligations that are capable of resulting in an outflow of resources meet the definition of a liability even if the likelihood of an outflow is low'.

12. We disagree with this change in principle, and believe that it would make financial reporting information less useful, but are also concerned about the wide-ranging impact the change will have. The IASB is already conducting a review of its conceptual framework, with a view to agreeing a common framework with the US Financial

Accounting Standards Board, which may redefine a liability. In addition, projects on revenue recognition and insurance contracts are closely related to this project and more effort should perhaps have been made to link these projects properly and in a co-ordinated fashion.

13. Our preferred approach is therefore that liabilities should not be recognised unless an outflow of resources is probable. This probabilistic assessment of outflow would be made having regard to the unit of account implicit in the business model (see paragraphs 15 and 16 below). Where there are potential liabilities that, on our preferred approach, would not be recognised, it would be more useful to provide narrative explanations about them in the notes to the accounts rather than to put them in the balance sheet based on unreliable estimates of probabilities. 'Stand-ready' obligations, as described in paragraph 19 of the working draft standard, are all likely to fall into this category. It is in any case unclear what stand-ready obligations are or why they are included in the proposed standard. At the moment, they are inadequately distinguished from normal business risks. If the reason that stand-ready obligations have been introduced into the proposed standard is that they are intended to deal with guarantees, it would be better to do so explicitly.

14. The Board also ought to consider specifically what the outcome should be where an entity believes that a claim that has been made against the entity has no merit, but nevertheless for good reasons – to avoid judicial uncertainty or reputational danger and to free management time and attention – the entity intends to settle. As there is no present obligation, it would appear in such circumstances that no provision could be made and the amount of settlement would only be recognised when paid. We query whether this is an acceptable financial reporting consequence of the loss of the probability of outcome criterion.

The expected value approach

Reliability

15. We can see the practicality of a probability-weighted expected value approach to the measurement of liabilities when making estimates for large populations of items for which there are statistics on historical experience, as in the case of insurance liabilities. Insurers devote significant effort to collecting historical data covering as large a population of relevant items as possible and to considering a range of probabilities for future outcomes. This work is an essential part of their business model and they are therefore well-equipped to make probabilistic forecasts of liabilities' future value. Importantly, in their case, the unit of account is a portfolio, not a single liability. So for liabilities of this type a probability-based estimate of expected value may well be appropriate. The accounting thus reflects their business model and the unit of account.

16. However, we continue to believe that a probability-weighted approach will be impracticable for liabilities for which data is not available to support a statistical approach and which are not managed on a portfolio basis, i.e. where the unit of account is one liability. One key question is reliability. This is perhaps clearest where the liability relates to a single uncertain future event. Estimates of the probability of single events are inherently less reliable than estimates for large populations of homogeneous items. Reliability also declines the lower the degree of probability. So, for example, where people think that the probability of something is 1% or 5% or 10%, we may suspect that in fact they have very little idea of the actual probabilities involved. They just think that the event is unlikely. To imagine that the event to which they attach a 10% probability is indeed ten times more likely than the event to which they attach a 1% probability would be to take an unrealistic view of people's ability to attach precise probabilities to single

future events. Probabilistic measurements of such liabilities would therefore be inherently unreliable and verifiability, including auditability, will be a fundamental problem for preparers and auditors.

17. We therefore conclude that one result of applying the probability-weighted expected value approach would be that situations in which the expected value of a liability could not be measured reliably would become extremely common rather than, as the Board suggests at paragraph BC15(c), extremely rare. Under the ED, it should follow that in such cases the liability would not be recognised. A standard that does not recognise many expected, but uncertain, liabilities just because there is insufficient statistical data to support the estimates would not be a satisfactory outcome and we do not believe this is the Board's intention.

18. In our view, the current 'best estimate of most likely outcome' approach that has been used in practice for the measurement of these types of provision works satisfactorily in practice and avoids unrealistic assumptions about people's ability to estimate the probabilities attaching to possible outcomes. No doubt best estimates of most likely outcomes are often wrong, but they will be less badly wrong than estimates of unlikely outcomes.

Usefulness

19. We are aware that there are varied views on the usefulness of the expected value approach once one moves away from the large portfolio approach – for example, for large, one-off, binary outcome liabilities. The size and behaviour of large portfolios mean that the expected value approach can produce useful information, although arguably all that is happening is that a most likely outcome is being assessed for each item, but using a short-cut of probabilities across a large population borne of long experience. We assume that such a short-cut approach would be acceptable, but we would be concerned if standards set theoretical requirements that cannot be made operational in practice by many, if not most, preparers.

20. Difficult problems arise, however, where, rather than a range of expected outcomes, there are say just two possibilities – eg, a 40% probability of one outcome with a positive cost and a 60% probability of the other outcome with a zero cost. On balance, we do not think that recognising a liability for 40% of the possible positive cost would provide a useful number in these circumstances. This is especially the case in circumstances where the costs cannot be laid off by disposal or insurance, ie, there is no 'market' for the liability.

21. The ED points out that it is a consequence of the probability-weighted approach that 'The expected value is unlikely to be the amount that an entity ultimately pays to fulfil the liability.' The Board appears to regard this as an acceptable result of its proposals. In our view, by contrast, it would be unfortunate. Financial reporting provides useful information where (amongst other things) it helps users to forecast future cash flows. We believe that amounts for liabilities are more likely to do this where they correspond with actual outcomes. The Board's apparent position, that it is more useful to have amounts that are unlikely to correspond with actual outcomes, seems to us to be unconvincing.

22. In an appendix to this submission, we consider the Board's reasons, as set out in the ED's Basis for Conclusions, for rejecting the arguments against the probabilistic expected value approach.

Uncertainty about existence of present obligation

23. We do not believe that the proposed requirements at paragraphs 13-16 of the working draft standard will resolve preparers' uncertainties about whether an obligation exists. Paragraph 13 lists only two sources of uncertainty, but a number of others are important and are not addressed by the working draft. Omitted factors include uncertainties regarding counterparties' information and intentions. Uncertainties may also be particularly important where the obligations arise from constructive obligations rather than the legal or regulatory events that are the main focus of paragraphs 13-16. Preparers are unlikely to understand how they should apply the proposed standard in these respects.

Scope of the working draft

24. Care needs to be taken in properly defining the scope of the proposed standard. At present the working draft only applies to liabilities. However, it also includes at paragraph 51 (and potentially the following paragraphs on restructuring activities) disclosure requirements for items that are not liabilities, and which are therefore on the face of it scoped out of the standard.

25. We believe that there are a number of issues with the application of the approach in the standard to financial guarantees. In particular, accounting for guarantees on a fundamentally different basis to 'vanilla' loan products does not seem consistent with the notion of comparability when these are in fact loan-type products. More importantly, perhaps, determining a fair value for these items (which is what seems to be required) is not straightforward, and so there will be less comparability between reporting entities than is currently the case.

Contingent assets

26. Paragraphs 31-35 of IAS 37 contain useful requirements on contingent assets. These would apparently disappear when IAS 37 is replaced. This is an unannounced change that will cause confusion for preparers and inconsistencies in practice as businesses try to apply the principles in the *Framework for the Preparation and Presentation of Financial Statements* to issues that would be best dealt with in a standard. We believe that IAS 37's requirements on contingent assets should therefore be retained.

27. It may be that the reason the Board proposes that the requirements on contingent assets should disappear is that it does not know where to put them. There are several possibilities. The 2005 ED suggested that the material should be in IAS 38, but it is not clear that contingent assets are intangibles in the main sense used in the standard. Another option, perhaps a temporary one, would be to retain a rump IAS 37 that deals purely with contingent assets. Another option would be to include this material in the proposed IFRS on liabilities. This may seem inappropriate at first sight, but the logic that led to provisions, contingent liabilities and contingent assets being treated together in IAS 37 is still applicable even though it is proposed that 'contingent liabilities' should disappear as a separate category. Another, more long-term, though not wholly satisfactory, option might be to deal with contingent assets as part of a revenue recognition standard. However, not all contingent assets are related to problems of revenue recognition. Whatever difficulty there may be in finding the right home for these requirements, it does not justify losing them altogether.

RESPONSES TO SPECIFIC QUESTIONS

Q1: 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?

28. We do not agree with the approach in paragraphs 36A-36F if such an approach leads invariably to use of the expected loss model. Our objections are noted in the Major Points section above. In our view, the most likely outcome approach is preferable. But there will be circumstances – eg, for insurers – in which a probability-weighted approach is the best way of estimating the most likely outcome.

29. We also suggest a couple of changes. At paragraph 36B(a), we suggest that the words 'or settle' should be added, so that it reads 'the present value of the resources required to fulfil or settle the obligation, measured in accordance with Appendix B'. Settlement is a common form of relieving obligations, and it is not clear why it should be omitted. Possibly the Board intends 'cancellation' of liabilities at 36B(b) to include settlement, in which case this needs to be stated explicitly. Indeed, even if this is the case, it would perhaps be better to refer to settlement rather than cancellation.

30. There will be occasions when this approach leads to the wrong answer in circumstances other than those to which we have already objected. A firm's interests might require it to take a broader view of how it deals with a particular liability that goes beyond deciding what method of relieving it results in the least cost. For example, where the liability is viewed by the business as part of a larger relationship with a customer, it may make sense, eg, for the business to fulfil its obligation by performance even where cheaper methods of discharging it are available. More useful information will be provided if the measurement of the liability reflects the method of relieving it that will actually be adopted, even if this is not the least cost option.

31. Paragraph B1(b) of Appendix B states that measurements of amounts needed to fulfil an obligation should include a risk adjustment, described in more detail at paragraphs B15-B17. While in principle we accept the logic of a risk adjustment in the measurement of liabilities, we do not think that the guidance makes clear what exactly the intention is in incorporating such an adjustment or how it should be measured.

32. A consequence of the least cost approach is that the measurement of 'cost' becomes important – as it is in other areas of financial reporting such as the measurement of inventories or self-constructed plant. It would therefore be helpful to have more guidance on which costs should be included and which excluded in these measurements. This would be a good question to deal with, in part, through additional examples. We in any case disagree with the inclusion of legal costs – as suggested in paragraph B7(b) – in calculating relevant future outflows as there is usually no obligation to continue to incur legal costs.

33. There is a risk that the basis of measurement set out in paragraphs 36A-36F will be seen as a fair value approach. We recognise that there are differences between the ED's proposals and fair value as the IASB proposed it should be measured in the 2009 ED *Fair Value Measurement*. But it may be helpful for the Board to spell out the differences so that no misunderstandings arise.

Q2: 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?

34. We do not agree that, as proposed at paragraph B8(b), measurement of the liability should in certain circumstances include a margin for own profit on performance. On this point, we agree with the arguments in the dissenting views at paragraphs AV2-AV4 of the ED. As stated there, the proposed approach will provide less useful information on future cash flows and will distort performance reporting as, first, a cost is reported based on the imputed margin and, later, a profit is reported as this element of the liability is unwound on performance.

35. Also, measuring a liability in this way will not meet the objective set out at paragraph 36A of the proposed standard as it will not provide a measure of an amount that a business would rationally pay. For example, a business would not rationally pay a contractor to do work that its own employees could perform more cheaply.

Q3 – 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?

36. We support the proposed exceptions.

APPENDIX: ARGUMENTS ON THE EXPECTED VALUE APPROACH

A1. At paragraphs BC14-BC18 of the ED the Board sets out its reasons for rejecting the criticisms made of its probabilistic expected value approach to the measurement of liabilities. We consider these below.

A2. BC14(a) states that investors 'would take into account all possible outcomes, not only the most likely one'. Against this, we would observe that financial reporting should not necessarily follow the example of valuation techniques used by investors. There are many items to which investors would attach a value that are appropriately either not valued in accounts or valued at different amounts from investors' valuations. Financial reporting is intended to provide useful information to investors, not to replicate their valuations. We also question the factual basis of the Board's claim. In many cases, investors have no better idea than preparers of all possible outcomes. So while in theory they might like to be able to take into account all possible outcomes, in practice this is not realistic.

A3. BC14(b) states that managers know more than investors about the business's liabilities, so their valuation of them provides useful information. We agree that managers usually know more than investors on such matters, but in many cases doubt whether this information is best conveyed by recognition and measurement in the balance sheet. But often gaps and uncertainties in the information available to managers mean that they are unable to make reliable measurements. In our view, excluding situations where statistically valid conclusions can be drawn from the data, any estimate of low probability is unlikely to be sufficiently reliable to justify recognition and measurement. In such cases, narrative disclosures are likely to be more useful to investors than dubious attempts at probabilistic measurement.

A4. BC15 rejects the claim that estimates of expected value are less reliable than estimates of most likely outcome. B15(a) states that reliability does not mean correspondence with actual outcomes. This relates to the point made at paragraph 17 of our main submission. We accept that where circumstances change significantly between the balance sheet date and the date of the actual outcome, it is possible that a reliable measurement at the balance sheet date will differ from the eventual outcome. This would be the case, for example, where the balance sheet valuation is based on a price from an active and liquid market, and this price subsequently changes. However, this is not the kind of situation that either IAS 37 of the proposed IFRS are designed to cope with. The problem here is liabilities for which it is often difficult to know either whether they exist or, if they do exist, how they should be measured. In these cases, if managers succeed in producing estimates that actually match outcomes it should, in our view, be regarded as a matter for congratulation rather than rebuke. Yet clearly, as the Board indicates, expected values for liabilities will not usually match actual outcomes. This seems to us to be an untenable view of what constitutes reliability.

A5. BC15(b) claims that estimates of expected values and of most likely outcomes would be based on similar information, so would have similar degrees of reliability. We accept that the information underlying the two estimates might well be the same in many cases. But we dispute that the two very different types of measurement emerging would therefore have equal reliability. If the same data are used to answer different questions, it does not follow that all the answers will be equally reliable.

A6. BC15(c) notes that in the 'extremely rare' situations that a liability cannot be measured reliably, it does not have to be recognised. We believe that such situations are much more common than the Board's approach allows for. Indeed – as noted at paragraph 17 of our main submission – we believe that, under the ED's proposals, such situations would become extremely common.

A7. BC16 rejects the argument that a requirement to measure expected values would be unduly onerous. While in our view such a requirement will create unnecessary work if preparers comply with it conscientiously, this is not our main concern.

A8. BC17 rejects the argument that expected value disclosures would prejudice the position of defendants in litigation. While we do have some concerns that conscientious compliance with an expected value requirement would have this effect, again this is not our main objection to the proposal.

A9. BC18 rejects concerns about convergence with US GAAP. We agree that 'requiring entities to measure liabilities on the basis of their most likely outcome would [not] contribute to convergence'. But we find it surprising, in view of the effort that the IASB devotes to convergence with US GAAP, that it would propose such significant changes to IFRS without apparently intending to reduce differences with the US. We note that discrepancies between IAS 37 and US GAAP in relation to legal contingencies were highlighted in the SEC's November 2008 *Roadmap for the Potential Use of Financial Statements Prepared in Accordance with International Financial Reporting Standards by US Issuers* and referred to again in its February 2010 *Commission Statement in Support of Convergence and Global Accounting Standards*.

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