Project **Liabilities—IFRS to replace IAS 37**

Topic

Comment letter summary – main issues

This appendix summarises the main issues raised by respondents to:

(a) the limited-scope re-exposure draft ED/2010/1 *Measurement of Liabilities in IAS 37;* and

(b) the working draft IFRS that the Board posted to its website during the comment period.

The comments discussed in this appendix include those that the staff think will affect the Board's decision on how to proceed with the project:

(a) general comments on the *project* as a whole (section 2).

(b) comments on the main aspects of the *measurement requirements and guidance* proposed in the exposure draft (section 3).

(c) additional comments on the *recognition criteria* set out in the working draft IFRS. The Board did not invite comments on the recognition criteria because it had exposed them for comment in 2005. However, many respondents used the opportunity to express their continuing concerns about the criteria (section 4).

(d) comments on *due process* (section 5).

This appendix excludes comments on issues that the staff judge will not affect the Board's decision on how to proceed on this project. The staff will include these

This paper has been prepared by the technical staff of the IFRS Foundation for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

comments in future Board papers (to the extent that they remain relevant after the Board has taken its decision on how to proceed). The comments that are not included in this appendix are primarily:

(a) comments on detailed aspects of the proposed measurement guidance;

(b) suggestions for enhancing the disclosure requirements; and

(c) a variety of comments on the requirements and guidance in the working draft IFRS dealing with *identification of liabilities.* The responses do not indicate any major, widespread concerns about this section of the IFRS.

(d) requests for more guidance on sundry matters, such as:

  (i) identifying onerous contracts; and

  (ii) recognition of contingent assets.

IASB Staff paper

Main comments on ED/2010/1 Measurement of Liabilities in IAS 37

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1 PROFILE OF RESPONDENTS

Type of respondent	Number	Other information
Users—investors and investment analysts	7	International, UK, France and Japan
Stock exchanges	3	IOSCO, Hong Kong and India
Industry regulators	4	Mainly financial services
National accounting standard setters	19	
Preparers (inc. representative bodies)	114	See next table ↓
Auditors	13	Mostly international firms
Accountants' representative bodies	27	
Lawyers	5	Mostly in North America
Valuation specialists	5	
Academics and individuals	14	
Total	**211**	

Preparers – sector analysis

In general, preparers have responded from all regions, with half or more of the respondents in each sector being European.

Sector	Number	Other information	Particular concerns
Power and utility	13	Mostly Canadian	Environmental liabilities
Oil, gas and mining	9		
Pharmaceutical	6	Europe and US only	Litigation
Insurance	9		
Other financial services	22		
Other sectors	37	15 diverse sectors	
Business groups representing range of sectors	18		
Total	**114**		

2 GENERAL COMMENTS ON PROJECT

2.1.1 Some respondents express explicit support for the project as a whole. In particular:

(a) a few respondents, mainly preparers, explicitly support efforts to clarify the existing measurement requirements and acknowledge that aspects of the existing requirements are unclear. In particular they highlight divergent practices in relation to:

(i) the meaning of best estimate;

(ii) the extent to which indirect costs are included in the measurement of liabilities; and

(iii) discount rates.

(b) one national standard setter also refers to the importance of other aspects of the project. The respondents hopes that others will not overlook the 'significant improvements' to the guidance on identifying liabilities.

(c) one accountancy body agrees that the IASB cannot realistically wait for the completion of the conceptual framework project and supports the direction of this project so long as the measurement principles being developed are consistent with those being developed in other (eg revenue and insurance contracts) projects.

2.1.2 However, a substantial number of other respondents do not support the continuation of the project in its current form. Most go on to specify aspects of the proposed recognition and measurement requirements with which they disagree (as discussed in sections 3 and 4 of this appendix). In addition, some respondents—mainly European preparers—express a view that:

(a) IAS 37 works well in practice and doesn't need to be replaced. It is well understood and not a significant source of divergence—as demonstrated by the lack of referrals to the IFRS Interpretations Committee in recent years[1] and by comments from CESR that enforcers have not encountered divergent practices either.

(b) if there are divergences in practice, these could be eliminated without radical reconstruction of IAS 37, ie within a framework of a 'most likely outcome' measurement approach.

(c) widespread opposition to the proposals in Europe increases the risk that the EU will not endorse them. Non-endorsement would impose substantial costs on European companies with US listings.

2.1.3 Some respondents—of various backgrounds—suggest deferring the project. The main reasons they give are that:

(a) the issues concerning liability measurement that are being addressed in this project—such as the definition of a liability, the removal of the 'probable outflows' recognition criterion, measuring assets based on prices and using expected values— should be addressed at a conceptual framework level first.

(b) the IASB should at present be devoting its limited resources to its higher priority projects. Its need to focus on other projects means that it is unlikely to resolve the issues in this project in a timely manner.

(c) the recognition and measurement proposals are contentious and have divided views among Board members. If the Board deferred this project until after 2011, it would then have more time to re-think the proposals.

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[1] Staff note: because the IASB has been conducting this project since 2002, most requests for clarification have been directed to the IAS 37 project staff, not the IFRS Interpretations Committee. The IFRS Interpretations Committee has issued two interpretations of IAS 37 since 2002. These are IFRIC 5 *Rights to Interests Arising from Decommissioning, Restoration and Rehabilitation Funds* and IFRIC 6 *Liabilities arising from Participating in a Specific Market—Waste Electrical and Electronic Equipment*.

(d) the Board should finalise the revenue, insurance contracts and/or leasing projects first. In particular, it should finalise the requirements for insurance contracts before mandating risk adjustments in other IFRSs.

2.1.4 Ten US respondents recommend that the IASB should not conduct this project on its own. It should instead commence a joint project on contingent liabilities with the FASB. These respondents argue that:

(a) the SEC has identified *existing* IAS 37 requirements for litigation as a potential block to US adoption of IFRSs. The problems arise because IAS 37 has a lower recognition threshold than US GAAP, different measurement requirements and requirements to disclose expectations regarding the outcome of the case. The current proposals do nothing to address the concerns. In fact they increase divergence.

(b) the IASB should follow the FASB's lead in addressing preparer concerns.

(c) a longer term project is needed for another reason anyway, ie to address disclosure requirements. The IASB could make use of the work that the FASB has already done on improving FAS 5 disclosure requirements.

(d) over the next year, the IASB should be focusing its scarce resources on achieving the goals of the Memorandum of Understanding, and other projects that promote convergence.

2.1.5 Twelve other, geographically diverse respondents, while not necessarily seeking to halt or change the direction of this project, encourage the IASB to work with the FASB in the longer term to eliminate remaining differences, incorporate the new FASB disclosure requirements and incorporate some discussion of existence uncertainty versus measurement uncertainty in a future common conceptual framework.

3 COMMENTS ON MEASUREMENT REQUIREMENTS

3.1 Measurement objective

Proposal

36A An entity shall measure a liability at the amount that it would rationally pay at the end of the reporting period to be relieved of the present obligation.

3.1.1 Some respondents express explicit support for the proposed measurement objective (although some then go on to disagree with aspects of the requirements). They note in particular that the proposed objective is more precise than the existing objective, leaving less scope for divergent interpretations. These respondents are mainly organisations who support valuation-type approaches to liability measurement in general. They include three user groups, but only a small proportion of preparers.

3.1.2 Not many respondents state explicitly that they oppose the measurement objective. However, the opposition of many respondents is implicit in the reasons they give for opposing the requirements that flow from the objective. See Section 3.3 *Measuring Fulfilment Amount—Expected Values for Single Obligations*. The few respondents who express explicit concerns about the measurement objective argue that:

(a) the objective should be to predict future costs, not measure a current exit price ('fair value by stealth'). Entities often cannot transfer or cancel liabilities within the scope of IAS 37 or can do so only at prohibitively high prices.

(b) the objective is unclear and lacks a unifying principle. It inappropriately mixes market and entity-specific inputs; or

(c) the objective is not consistent with the measurement objectives in other IFRSs.

3.2 Measurement hierarchy

Proposal

36B The amount that an entity would rationally pay to be relieved of an obligation is the lowest of:

(a) the present value of the resources required to fulfil the obligation, measured in accordance with Appendix B;

(b) the amount that the entity would have to pay to cancel the obligation; and

(c) the amount that the entity would have to pay to transfer the obligation to a third party.

3.2.1 Some respondents—across a range of categories and regions—explicitly support the ‘lowest of’ requirement in paragraph 36A, mainly on the grounds that the notion of value-maximising behaviour is consistent with economic and market theory and other IFRSs. Some of those respondents acknowledge the link between this notion and the word ‘rationally’ in the measurement objective. Others agree that specifying a hierarchy helps to clarify some of the ambiguities in IAS 37 and the 2005 exposure draft:

3.2.2 However, some other respondents—again across a range of categories and regions—disagree with the ‘lowest of’ notion. The think that liability measurements should instead reflect the outflows that the entity expects to incur. In other words, entities should take into account cancellation or transfer prices only if management intends to cancel or transfer the obligation or has a recurring practice of doing so, or if cancellation/transfer would be commercially sensible taking into account all external and internal factors.

3.2.3 The main arguments made in support of this view are that:

(a) rationally, entities might not always choose the lowest cost settlement route. For example, they might decide to fulfil an obligation themselves to protect their reputation, maintain relationships with a customer, avoid sharing information with third parties, or retain control over the cash flows. Alternatively, they might transfer obligations to avoid reputational risk arising from carrying out the work or to eliminate other risks. In such circumstances, measurements of the lowest amount would not provide relevant information.

(b) a requirement to measure the liability by reference to the intended method of settlement would also avoid the need to identify three different measurements.

3.2.4 One respondent suggests that the 'lowest of notion' should be replaced by a 'highest of' notion, because:

(a) in normal market conditions, the three amounts specified would be very similar so any large gap suggests a mistake;

(b) artificially low transfer prices might be accepted by related parties; and

(c) a 'highest of' notion is more prudent.

3.3 Measuring fulfillment amount—expected values for single obligations

Proposal

B3 The range of outcomes and their effects shall be taken into account by estimating the expected present value of the outflows. … The expected present value is the probability-weighted average of the outflows for the possible outcomes.

3.3.1 The decision that even single obligations should be measured by reference to their expected value, rather than their most likely outcome, continues to be one of the most controversial aspects of this project. The Board did not invite comments on this aspect of the proposed measurement requirements, which it had already exposed in 2005. However, two thirds of respondents express a view. Users of financial statements tend to be more supportive than other respondents, so their views are discussed separately below.

Responses from users of financial statements

3.3.2 The Board received seven groups representing investors and analysts. Of these, six groups explicitly comment on the requirement to measure single obligations using expected values:

(a) one–CL205 *French Society of Financial Analysts*—expresses complete opposition. It thinks that the expected value of a liability with a low probability of outflows is not relevant. It would prefer entities to recognise the outflows that are likely to occur and disclose other outcomes.

(b) one group—CL65 *Security Analysts Association of Japan*—reports that views among its members are divided. Although a minority of members think that expected value measures better reflect 'economic realities', the majority think that, if one outcome is much more likely than others, the entity should recognise the most likely outcome and disclose others.

(c) two—CL22 *Corporate Reporting Users Forum and* CL207 *CFA Society of the UK*—support expected values in general, regarding them as more robust and transparent than measures based on most likely outcomes. However, these groups think that in some cases, the uncertainties are too great for the liability to be measured reliably and if only two outcomes are possible, measurement of one outcome and disclosure of the other would be sufficiently useful, and less burdensome. In such cases, these groups would prefer enhanced disclosures, eg of the ranges of possible outcomes.

(d) two groups—CL199 *International Corporate Governance Network and CL208 CFA Institute*—express unqualified support for expected value measures, again on the grounds that the measures are more robust and transparent than measures of the most likely outcome. The CFA Institute goes on to challenge the arguments that some other people put forward against expected values:

> … We recognise the inherent difficulty of assigning values and probabilities to outcomes which may be difficult to estimate and that the actual amount paid by an organization is likely to differ from the expected value of the outflows. However, we do not believe these are reasons not to utilize this model. The assignment of values and probabilities may be subjective but we do not believe any more subjective than determining a point estimate. Further, though expected value may not equate to the actual cash flow ultimately required to settle the obligation, as time progresses and uncertainties resolve themselves the expected value and amounts paid should converge as uncertainties abate and outcomes become more certain. The disclosure of the development of such expectations, along with the key information regarding the computations themselves, can provide decision-useful information to investors. … For those who believe the most likely outcome is the better measurement of such obligations, we would suggest having management disclose their view of the most likely outcome in the notes. CL208 CFA *Institute*

3.3.3 All of the users also emphasise their desire for more detailed disclosure about the uncertainties and assumptions. The staff are collating the comments on the disclosure requirements for discussion at a future meeting.

Other respondents – supporters of expected values

3.3.4 Of the other respondents—ie those who are not users of financial statements—only a few express explicit support for expected values Their reasons are that:

(a) expected values are more objective and robust measures than 'best estimates' and impart greater discipline in the measurement of liabilities.

(b) if outcomes are uncertain, expected values give the most appropriate measure for decision-making. The calculations need not be too complex and if there is any risk that investors will not understand the relationship between the expected value and the most likely outcome, the difference could be clarified via disclosures.

Other respondents – opponents of expected values

3.3.5 In contrast, most of the remaining 204 respondents—primarily preparers, accountancy bodies, auditors and European and Asian standard setters—express opposition to requiring expected value measurements for single liabilities.

3.3.6 The main reasons these respondents give is that they think that expected value measurements:

(a) do not provide users with relevant information;

(b) can be unreliable; and

(c) can be unduly costly to estimate.

Each of these concerns is explained in more detail below.

Concerns about relevance

3.3.7 The most frequently-expressed reason given for opposing expected values is that, in the respondents' view, expected values are not relevant measures of single obligations—measurements of the most likely future outflows (along with disclosure of other outcomes) are more relevant. Respondents typically note that, applying an expected value approach, obligations with only two possible outcomes are measured at amounts that will never be paid (an amount that inevitably will be 'wrong'). In their view, low-probability outcomes distort the measurement of the liability.

3.3.8 These respondents also note that recognising low probability liabilities in one period and then (probably) releasing them in later periods will lead to income statement volatility. In their view, this volatility distorts the income statement, especially because the probabilities can be difficult to measure reliably.

3.3.9 Several of the respondents explain their views by reference to a particular example. The example involves a liability with a very high probability (say 99%) of a low outflow (say CU1,000) and a very low probability (say 1%) of a much larger outflow (say CU100,000). They note that the expected value (CU1,990) is not an amount that the entity will ever pay and that small changes in the probability estimates will cause large changes in the liability every period until the highly probable event of a CU1,000 outflow occurs. They argue that the resulting volatility is meaningless, especially because the probabilities are difficult to estimate accurately.

3.3.10 A few of these respondents specifically refer to the objective of financial statements set out in the IASB *Framework*. They interpret terms such as 'predictive' as meaning 'predictive of the most likely future cash flows'. Accordingly, they argue that expected value measures do not provide predictive information.

Concerns about reliability

3.3.11 A second widespread concern is that entities cannot estimate reliably the expected values of some liabilities in the scope of IAS 37. Problems arise when entities cannot draw upon historical experience. Except for large pools of relatively homogeneous items, entities cannot usually estimate probabilities reliably—especially the probabilities of the less likely outcomes. In particular, it is sometimes not possible to determine (and external advisers will be reluctant to provide) an array of probabilities for litigation and remote guarantees. Even simple lawsuits can involve many variables, some of which can be highly unpredictable. For example, the outcome of a single lawsuit can vary depending on the timing of the case, the jurisdiction or venue, the temperament and/or experience of the judge, the decision as to who will render the verdict (a judge or jury), the amount of press coverage, the political environment and the qualities and characteristics of the plaintiff. Expected value techniques should be used only when the characteristics of the item being measured are amenable to statistical estimation.

3.3.12 Many of these respondents note that the draft IFRS would not require entities to recognise liabilities that they cannot measure reliably. However, the respondents also note that the draft IFRS describes such cases as 'extremely rare'. This constraint would prevent entities from applying the criterion as often as it is needed.

3.3.13 One US lawyer (CL119) gives a detailed explanation of the approaches defence lawyers use to estimate amounts that clients should pay to settle litigation. His explanation challenges the Board's assertion (in paragraph BC16 of the exposure draft) that entities could use for accounting purposes the same models that they use to support settlement offers. In particular, he argues that defence lawyers do not estimate all possible outcomes and their associated probabilities, because to do so 'would amount to little more than guesswork'. Instead, lawyers take into account a variety of considerations including the nature of the litigation, the amount claimed, anticipated cost, the opposing party, prior experience with the lawyers involved, the

court, the applicable law, the underlying evidence, potential outcomes, and the settlement amount of comparable lawsuits.

3.3.14 Other specific concerns relating to the reliability and verifiability of expected value estimates are that:

(a) the errors in estimates of expected values can be larger than the errors in estimates of any single outcome or highly sensitive to small changes in the estimated probabilities of extreme outcomes. The increased number of estimates required would provide more scope for manipulation.

(b) the highly subjective management judgments required to apply the approach will be difficult for auditors to verify. Applying the terms of the current treaty between auditors and the American Bar Association, lawyers would not provide auditors with the necessary information.

(c) difficulties in liabilities might lead to fewer being recognised.

Cost-benefit concerns

3.3.15 A third widespread concern is that the costs of applying an expected value approach would be excessive, and would outweigh any potential benefits:

(a) the general concern is that the approach will require more costly and complex processes and systems. Further, entities do not necessarily have the information or expertise required, so will have to rely on external advisers.

(b) six Canadian companies with significant decommissioning obligations argue more specifically that an expected value approach is not suitable for complex decommissioning and restoration provisions because there are too many variables for management to identify a limited number of discrete cash flow scenarios. Entities can have thousands of such liabilities, each of which depends on tens or hundreds of uncertain variables. Alternatives should be allowed in those circumstances.

Other concerns

3.3.16 A fourth concern—expressed by CL153 *The Law and Accounting Committee of the American Bar Association* and some preparers with US interests— is that a an expected value approach would increase the practical difficulties for entities defending lawsuits in the US legal environment:

(a) more information about the possible outcomes of lawsuits needs to be shared with auditors, and hence more potentially prejudicial information risks losing its attorney-client privilege.

(b) the amount recognised (which will also be subject to discovery) will be viewed as a 'floor' by the other party in any negotiated settlement, leaving the entity with little or no ability to negotiate below that amount. Although entities need only disclose aggregate amounts for each class of liability, the aggregate amounts will be very revealing if entities have only one or two major liabilities or if lawsuits are in different classes.

(c) entities will become more vulnerable to shareholder lawsuits because the measurements of their liabilities will be unreliable and volatile.

3.3.17 Two respondents express a concern that a requirement for expected value measurements in IAS 37 would then be used to justify requiring expected values in other IFRSs, for example for uncertain tax positions in IAS 12 *Income Taxes*.

Suggested alternatives

3.3.18 Most respondents who oppose (or have some concerns about) expected value measurements would prefer to measure all liabilities within the scope of IAS 37 at their most likely outcome (with the most likely outcome for portfolios of obligations being measured at a portfolio level). Some suggest that entities should be able to choose the approach that they consider gives the most useful information to investors.

3.3.19 Some respondents—including the users who are concerned about the reliability of some expected value measures—suggest permitting alternatives to expected values in specific circumstances, for example:

(a) requiring measurements based on the most likely outcome for:

(i) high impact/ low probability liabilities with only a small number of possible outcomes (eg win or lose).

(ii) one-off lawsuits, or other highly uncertain liabilities, for which there is insufficient evidence of the range of possible outcomes and the probabilities of each occurring.

(iii) liabilities for which one outcome is overwhelmingly more likely than any other.

(b) allowing entities to assume that outcomes have a normal distribution unless there is reliable evidence to the contrary, or if probabilities are not known. Entities would then use the mid-point of the distribution.

(c) keeping the measurement objective, but without prescribing how entities should estimate the amounts they would rationally pay to settle litigation.

3.4 Measuring fulfilment amount—outflows of services

Requirement to use contractor prices

Proposal

B8 Some types of obligation will be fulfilled by undertaking a service at a future date. Subject to the exception in paragraph B9, the relevant outflows for such services are the amounts that the entity would rationally pay a contractor at the future date to undertake the service on its behalf:

(a) if there is a market for a service, the amount is the price that the entity estimates a contractor would charge at the future date to undertake the service on the entity's behalf;

(b) if there is not a market for the service, the entity estimates the amount it would charge another party at the future date to undertake the service. The estimates shall include the costs the entity expects to incur and the margin it would require to undertake the service for the other party.

3.4.1 Only a few respondents explicitly support this proposal. They do so on the grounds that it would enhance comparability, avoid debates over which costs to include and/or reflect rational economic / market behaviour.

3.4.2 However, an overwhelming majority of respondents—of all types and from all regions, and including most investor and analyst groups—oppose the proposal. Most do so on the grounds that the resulting information would not provide relevant decision-useful information to investors. They argue that contractor prices do not represent real future cash flows but include hypothetical margins that 'distort' the income statement and tell users little about the underlying profitability of the business. Relevance is more important than comparability.

3.4.3 A second widespread concern is that the measurements would be difficult, and less reliable and comparable than those based on estimates of cost:

(a) market prices are less readily available than the Board suggests: there is, for example, no market for decommissioning nuclear power plants currently and fewer markets in smaller or less mature economies. Although some services can be contracted, there are not necessarily observable market prices so prices would need to be estimated, adding to their subjectivity. Contractor prices vary significantly and would require an appraisal of quantitative and qualitative characteristics in determining the preferred supplier. In some cases the only potential contractors are competitors.

(b) there is insufficient guidance on how an entity would measure the margin required in the absence of a market and on what constitutes a market. Benchmark data do not take into account the uniqueness of many obligations and most companies do not hold benchmark data anyway. The inclusion of a margin in the absence of a market would be very subjective (the entity is not actually competing for current work) and could provide an opportunity to management to manipulate results.

3.4.4 Other arguments put forward against the proposal are that:

(a) it is inconsistent with the measurement objective (which assumes rational value-maximising behaviour). The amount that the entity would rationally pay to be relieved of an obligation would depend on the expected costs of either fulfilling the obligation, or outsourcing it if cheaper. The value (or opportunity cost) of the services is an upper boundary.

(b) the proposal is inconsistent with requirements for self-constructed assets. IAS 2, IAS 16 and IAS 38 allow entities to include only their own costs, not any hypothetical margin.

(c) activities such as decommissioning one's own asset are *not* revenue-generating activities. So an entity should not recognise a profit from performing these activities ('transacting with itself'). Although decommissioning is part of the life-cycle of equipment, it is not a principal business activity upon which the entity seeks to earn a return. The difference justifies applying requirements in IAS 37 that are different from those in the proposed revenue and insurance contracts IFRSs. Some respondents argue that the proposal, taken to its logical conclusion, implies that entities should defer revenue from customers until decommissioning activities are complete.

(d) the Board's proposals would make unalike entities look alike. Entities able to carry out their own environmental rehabilitation would look the same as entities that have to hire contractors to do it for them. The measurement of the liability should reflect the entity's ability to manage the settlement of its obligations effectively. Management intentions are used in other IFRSs to determine accounting treatments.

(e) the guidance required for a cost-based model need not be 'essentially arbitrary' or excessively detailed. The guidance in IAS 2 *Inventories* is applied without problems.

(f) the requirement would set a precedent for other projects (eg for the measurement of onerous sales contracts in the new revenue standard).

(g) rate-regulated entities will over (or under) recover their costs over the life of the asset to be decommissioned if subcontractor prices are higher (or lower) than expected costs.

(h) the proposal is highly controversial and prolonging the debate will jeopardise the timely completion of the project as a whole.

3.4.5 Opponents of the proposal advocate measuring outflows on the basis of expected costs only, in line with the alternative views expressed in the exposure draft. Some of these respondents acknowledge that the Board would need to specify the costs that entities should include. Respondents variously suggest:

(a) requiring entities to include direct incremental costs only, ie excluding internal costs that would be incurred irrespective of the obligation. Any overhead that is not directly related to the service does not result in incremental future outflows of resources from the entity.

(b) requiring entities to include all 'directly attributable costs' applying similar guidance to that in IAS 16 *Property, Plant & Equipment* for self-constructed assets.

(c) requiring entities to include both the direct costs of fulfilling the obligation and the indirect costs of using the entity's existing resources in the fulfillment process (similar to the approach required by IAS 2 for measuring the cost of inventory).

(d) aligning the guidance with the guidance that the Board issues for onerous sales contracts in the proposed new revenue and insurance contracts standards.

(e) allowing entities to select the most appropriate approach for the circumstances.

Exception for onerous sales and insurance contracts

Proposal

As an exception to the general requirement in B8 for entities to measure service obligations by reference to contractor prices:

B9 If the obligation is an onerous contract arising from a transaction within the scope of IAS 18 *Revenue* or IFRS 4 *Insurance Contracts*, the relevant future outflows are the costs the entity expects to incur to fulfil its contractual obligations.

This exception would be required as a transitional arrangement only. It would apply only until the Board had issued new IFRSs to replace IAS 18 and IFRS 4.

3.4.6 Reflecting their preference for cost-based liability measurements, virtually all respondents agree with the proposed exception for onerous contracts arising from transactions within the scope of IAS 18 and IFRS 4. However, many go on to suggest that:

(a) the exception would not be necessary if all outflows were measured on the basis of expected cost. A comprehensive measurement principle should not result in exceptions.

(b) the exception should also apply to other liabilities—such as warranty obligations that will ultimately be within the scope of IAS 18 and IFRS 4 and onerous contracts for the supply of goods.

(c) the exception (and other transitional issues) could be avoided if the Board issues the new IFRS at the same time as it issues the revenue and insurance contracts standards.

(d) there seems to be no conceptual argument for measuring onerous sales contracts differently from asset decommissioning obligations. If anything, the arguments are stronger for including profit in the measurement of onerous sales contracts. The exception highlights the inconsistency between the proposals in this project and those in the revenue and insurance contracts projects and the need for completion of the revenue and insurance contracts projects and/or a more comprehensive measurement framework before IAS 37 is changed.

(e) all onerous contracts—including onerous sales contracts—are non-financial liabilities that should be within the scope of IAS 37, not the revenue standard.

3.5 Measuring fulfilment amount—risk adjustment

Proposal

B15 An entity shall consider the risk that the actual outflows of resources might ultimately differ from those expected. A risk adjustment measures the amount, if any, that the entity would rationally pay in excess of the expected present value of the outflows to be relieved of the risk.

3.5.1 Some respondents—across all categories and regions and including two user groups—explicitly support the requirement for a risk adjustment. They agree that there is a price for risk and that the values of two obligations with the same expected value but different spreads would differ.

3.5.2 However, many other respondents oppose, or at least have concerns about, the risk adjustment. These respondents include most of the auditors and user groups. Their main concern is that entities cannot reliably measure risk adjustments for liabilities within the scope of IAS 37. Methods used for large pools of risks (such as 'cost-of-capital' or 'quantiles' methods) cannot be applied to single obligations. The risk adjustment might give managers unwarranted latitude to manipulate the liability, and auditors little ability to disagree. This will lead to diversity in practice, especially given the lack of meaningful guidance.

3.5.3 In addition, some respondents express views that:

(a) risk adjustments are unnecessary with expected value measures: uncertainty is taken into account by probability-weighting the possible outcomes. Requiring a risk adjustment suggests that the expected value assessment was not thoroughly developed. The risk adjustment in IAS 37 is needed only if the liability is measured by reference to most likely outcome.

(b) the conceptual rationale for adding a risk adjustment is flawed. It assumes that entities are risk averse (rather than risk-seeking) and that investors would put the same price on risk as the entity management would. These might not be valid assumptions. In most circumstances, the entity would *rationally* pay only the expected value of the outcomes to be relieved of a liability. The exception would be if one of the adverse outcomes could ruin the entity. In such circumstances, the entity is likely to have insured the risk in some way.

(c) the risk adjustment does not provide useful information to users. It will not result in cash outflows and is unlikely to be well-understood. Users would be better served by appropriate disclosure of the risks and the range of possible outcomes. They could use these disclosures to make adjustments that appropriately reflect their own risk preferences.

(d) the risk adjustment increases complexity, placing undue burdens on preparers, which outweigh any benefit to users.

3.5.4 Many respondents—including both supporters and opponents of the risk adjustment—suggest there is insufficient guidance on measuring it. Respondents ask the Board to:

(a) explain the purpose of the risk adjustment. Does it attempt to measure the uncertainty about the extent to which the probability estimates are accurate, the benefit of transferring risk or an additional safety margin? Is it entity specific or market based?

(b) illustrate how expected values do not take account of risk using simple examples (in which the expected value is the same but the spread of outcomes is different).

(c) identify the factors that would affect the risk adjustment—such as the entity's past experience with similar liabilities, the quality of the underlying inputs—and which would tend to make the risk adjustment smaller or larger. (For example, the risk adjustment decreases as the number of outcomes reflected in the measurement increase and a single event would require a higher risk margin than a pool of homogeneous risks.) The Board could consider adopting guidance used by Canadian insurers on how to determine provisions for adverse deviations.

(d) specify whether entities should include diversifiable risks and if so, whether diversifiability should be considered from the entity or the investor's perspective. Some liabilities are unique to the entity and it might be wrong to exclude diversifiable risks.

(e) explain how the risk adjustment of 5 per cent has been arrived at in the illustrative example.

(f) explain why the adjusted discount rate is typically lower than a risk-free rate.

(g) clarify whether the adjustment should take into account only the variability of the outcomes, or also the reliability of the predictions.

(h) clarify whether and how an entity should incorporate risk preferences.

(i) illustrate the alternative methods of incorporating a risk adjustment and advise entities on which factors they should consider when choosing a method. The examples should show that using consistent assumptions, the liability is measured at the same amount, no matter which method is chosen.

(j) emphasise the need to apply caution to ensure that risk adjustments are not excessive.

3.6 Measuring fulfilment amount—discount rate

Proposal

B14 The expected outflows shall be discounted to their present value using rates that reflect:

(a) current market assessments of the time value of money; and

(b) risks specific to the liability (but only if and to the extent that the risk are taken into account by adjusting the discount rate rather than by the other methods discussed in paragraph B16).

3.6.1 Some respondents ask to specify whether the discount rate should take into account non-performance risk. Some of these respondents—including two of the large auditing firms—note that different interpretations of IAS 37 requirements at present are causing material differences in liability measurements. The differences are so large because the future cash flows for asset decommissioning obligations may occur very far in the future.

3.6.2 In addition, respondents ask the Board to clarify:

(a) whether the 'risks specific to the liability' might includes any other risk, such as liquidity risk.

(b) whether the non-performance risk (if included) would be that of an entity or a market participant and how the entity should recognise changes in non-performance risk.

(c) if and how the required rate is different from those specified in the exposure drafts on fair value measurement and insurance contracts.

(d) the appropriate use of real and nominal rates.

3.6.3 Several respondents argue that measurement of the expected value of the resources required to fulfil an obligation should *exclude* non-performance risk, consistent with the proposals for insurance contracts and at least until the Board has finalised the measurement chapter in the revised conceptual framework. In particular, there should be no requirement to *re-measure* liabilities to take into account changes in non-performance risk.

4 COMMENTS ON RECOGNITION CRITERIA

4.1 Background and proposal

4.1.1 At present, IAS 37 specifies three criteria that must *all* be satisfied before an entity recognises a liability:

- Criterion 1: it is probable (more likely than not) that a liability exists, ie that the entity has a present obligation;
- Criterion 2: it is probable (more likely than not) that the liability will result in a future outflow of economic benefits; and
- Criterion 3: the liability can be measured reliably.

4.1.2 The first criterion need be considered only if there is uncertainty about whether the entity has a present obligation—eg if an entity is defending a lawsuit or regulatory action. It might be uncertain:

(a) whether a particular event occurred—ie whether the entity committed the act of wrong-doing for which it is being sued; or

(b) how the law applies to that event—ie whether committing that act gives the entity an obligation to pay fines, penalties or compensation to the plaintiff.

4.1.3 Typically, the later court ruling will confirm both whether a liability existed at the reporting date and whether any outflows will be required. Thus for litigation liabilities, the first and second criteria often serve the same purpose. They both serve to prevent a defendant from recognising a liability if it is probable that the court will rule in favour of the defendant.

Proposed changes

4.1.4 The Board has tentatively decided to make two changes, both of which it exposed for comment in 2005:

(a) to *amend* criterion 1, removing the explicit more-likely-than-not threshold from the assessment of whether a liability exists. Instead of applying this threshold, managers would be required to consider all available evidence and 'judge whether an obligation exists';

(b) to *remove* criterion 2. As a result, any liability judged to exist (applying the amended criterion 1) would be recognised if it can be measured reliably.

4.1.5 The staff posted a paper *Recognising Liabilities arising from Lawsuits* during the comment period for the exposure draft. This staff paper aims to clarify the impact of the two changes for litigation liabilities. In particular, it emphasises that because Criterion 1 and Criterion 2 typically serve the same purpose, the removal of Criterion 2 would not significantly increase the number of litigation liabilities recognised.

4.2 Recognition criterion 1—a liability exists

4.2.1 Some respondents specifically refer to the Board's intention to amend criterion 1, removing the explicit more-likely-than-not threshold from the judgment about whether a liability **exists**. These respondents—who include the Law and Accounting Committee of the American Bar association and a number of US preparers—oppose the removal of this explicit threshold arguing that:

(a) without the threshold, the existence test is unworkable. It simply cannot be applied without a prescribed level of certainty.

(b) in the absence of an explicit threshold, people will start to apply their own thresholds and practices will diverge. The IASB had discussed replacing the threshold with 'indicators' of when an entity has a liability. However, those included in the working draft are not sufficiently robust to ensure consistent application.

(c) the Board has accepted the need for a more-likely-than-not threshold elsewhere, eg in judgments about renewal and purchase options in accounting for lease obligations and has not put forward persuasive arguments for removing the threshold from IAS 37.

4.2.2 The comments of a some other respondents—again including several US preparers—indicate that their concerns about removal of criterion 2, ie the 'probable outflows' outflows criterion, might be addressed, at least in part, if the more-likely-than-not threshold remained in criterion 1, ie for judgments about *existence*. In other words, their concern appears to be less about the change in focus from outflows to existence, and more about a wish to retain an explicit recognition threshold somewhere in the decision process.

4.2.3 Some respondents—mainly preparers, but also including the International Auditing and Assurance Standards Board and several accounting standard setters—ask for more guidance on applying the recognition requirements in situations in which it is uncertain whether an obligation exists. Some have pointed out that the Board had some difficulty in reaching its own conclusions in this matter and that the only guidance available is in a non-authoritative staff paper—which might not necessarily be supported by the Board as a whole. Specifically, respondents suggest that additional guidance should include:

(a) the guidance in the staff paper.

(b) more explicit acknowledgement that the likely outcome of legal case is one of the indicators of whether an entity has a liability or not. The entity should consider the likelihood of its position prevailing, taking into account the views of internal and external legal counsels and, if available, legal precedents in similar cases, which are likely to be the best available means of determining the current views of the courts.

(c) guidance on how exhaustive the search for 'available evidence' should be. A requirement to consider *all* available evidence is unduly onerous for entities to implement and auditors to verify: an entity should only have to consider *reasonably* available evidence. Alternatively, the guidance should use caveats similar to those in the proposed IFRS on fair value measurement (an entity need not undertake an exhaustive search) and IAS 36 *Impairment of Assets* (the requirements are subject to a cost-benefit constraint).

(d) guidance for entities in the early stages of litigation, when there is insufficient information for management to reach a judgment. Some respondents suggest that, if there is insufficient information on which to base a judgement, the entity should not record a liability.

4.2.4 A few respondents request that the Board revisits the wording in the staff paper. The paper uses terms such as 'without merit', 'no merit', 'lacks merit', 'valid claim', 'seriously prejudicial' and 'when resolved', which can be interpreted in different ways. ('Without merit' in particular is used in US standards to mean 'remote', which is not how it is used in the staff paper.)

4.2.5 Responses confirm that there are different views on how entities should account for situations in which management judge that an entity does *not* have an obligation to the other party but will probably nevertheless offer an out-of-court settlement:

(a) some respondents think that entities should recognise a liability. Non-recognition would lead to delays communication of relevant information about future outflows to users.

(b) other respondents agree with the proposal in the staff paper that the entity should not recognise a liability because it does not have a present obligation. They say that more guidance is needed in IAS 37 to clarify this point and eliminate existing divergent practices.

4.3 Recognition criterion 2—outflows are probable

4.3.1 The consequences of the removal of criterion 2 (the 'probable outflows' criterion) are set out in a staff paper *Recognising Liabilities Arising from Lawsuits*. Virtually all respondents appear to have read the staff paper and taken its guidance into account in their responses. Only a handful of respondents make comments suggesting that they assume that an entity defending a lawsuit would have to recognise liabilities whatever the likely outcome of the suit.

4.3.2 Despite not being invited to comment on the recognition criteria, a few respondents express explicit support for, or at least acceptance of, the removal of the probable outflows criterion. They argue that:

(a) the change will ensure that entities recognise and measure all liabilities that they can measure reliably. The existence and magnitude of liabilities become more apparent if they are 'on balance sheet'; and

(b) at present, people fail to distinguish existence uncertainty from measurement uncertainty. Changing the recognition criteria will help address this problem.

4.3.3 However, many continue to oppose the removal of the 'probable outflows' recognition criterion. This group includes almost all the European national accounting standard setters, most of the accounting firms and a significant number of preparers.

4.3.4 Many of these respondents argue that, in combination with the proposed changes to the measurement requirements, removal of the criterion would lead to less relevant information for users. Entities will need to recognise some liabilities (such as guarantees and undetected acts of wrong-doing) even if outflows are not probable. In such cases, disclosure of a possible outflow is more useful than recognition of an unlikely outflow.

4.3.5 One respondent notes that a PricewaterhouseCoopers survey of 50 analysts in 2007 found that 86% would prefer to reflect only probable events in the financial statements.[2]

4.3.6 Auditors in particular also argue that the 'probable outflows' criterion is a useful filter that avoids the need for consideration of whether a liability exists. They think the criterion is easier to apply than a 'judge whether a liability exists' criterion. In its absence, the requirements will be more complex to apply, leading to greater diversity. If removing the 'probable outflows' criterion will not affect the point of recognition for many lawsuits, there is no reason for removing it and imposing a more burdensome model in its place.

4.3.7 Other reasons that respondents give for opposing the removal of the 'probable outflows criterion' are that:

(a) recognition of a liability for an undetected act would increase the risk of future detection. Further, recognition of a liability following a claim would become an admission of guilt, rather than a prediction of the outcome. Therefore, recognition (and the loss of attorney-client privilege for any opinions required to support recognition) could prejudice the position of an entity and might lead to entities not recognising liabilities, or not providing auditors with evidence, for fear that it could be construed as an admission of guilt.

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[2] PricewaterhouseCoopers paper *Measuring Assets and Liabilities—Investment Professionals' Views February 2007* To put this comment into context, it is worth noting that:
- PwC framed its question in the context of the 2005 exposure draft proposals, which would have required entities defending lawsuits to recognise a liability, whatever the likely outcome.
- The survey also provides evidence of analyst support for expected value measurements: it reported that 86% of the analysts favoured a measurement model that uses probability-adjusted discounted cash flows.

(b) removal of the criterion would make the recognition criteria in IAS 37 inconsistent with those in the IASB *Framework*. If the IASB wishes to change conceptual criteria, it should change them only after wider debate within the conceptual framework project. Otherwise the IASB undermines the authority of the *Framework* and increases the risk of future changes to the proposed standard as a result of subsequent deliberations of the *Framework*.

(c) the Board has argued that removing the criterion would align IAS 37 with other IFRSs. However, consistency with other standards, such as IFRS 3 or IAS 39, is not important. Differences in the nature of the transactions—especially for assets and liabilities acquired in a business combination—justify different requirements. The differences have not caused major problems for users or preparers. The IFRS 3 requirements for contingent liabilities are controversial: if the Board wants consistency, it should amend IFRS 3, not IAS 37.

4.3.8 The arguments of some US respondents suggest their concerns arise primarily because of differences between US GAAP and the *existing* IAS 37, rather than the proposed changes to IAS 37. These concerns arise because:

(a) the 'probable' threshold for recognising contingent losses is interpreted in US GAAP to mean a threshold well above 'more likely than not'. Lawyers at present decline to give opinions on the outcomes of cases, except to identify the relatively few cases that meet the US definition of probable. If entities had to recognise liabilities at a lower 50% threshold, lawyers would need to provide opinions on the outcomes of many more cases to auditors. Communications with auditors are generally not privileged, so they are may be discoverable by claimants and government agencies, prejudicing the defendant's position.

(b) also because defendants would have to recognise more liabilities, they would be more exposed than they are applying US GAAP to class action lawsuits if the outcomes are different from the amounts recognised.

(c) the proposed *disclosure* requirements (which are the same in substance as those in IAS 37 at present) require disclosure of more sensitive information than the disclosures required by US GAAP. Entities will have to disclose information on which they will need advice from counsel. The disclosure of the information may constitute a waiver of attorney-client privilege, rendering the details of the advice from counsel on this matter discoverable by plaintiffs. The potential for waiver of privilege or loss of attorney work-product protection is not diminished by the preparer's ability to disclose aggregate measurements for a class of liabilities.

4.4 Recognition criterion 3—the liability can be measured reliably

4.4.1 At present, IAS 37 prohibits entities from recognising liabilities that are not capable of being measured reliably. However, it describes such liabilities as being 'extremely rare'. The Board proposes no changes to this aspect of IAS 37.

4.4.2 Some respondents—in particular North American lawyers and preparers—challenge the Board's assertion that entities will be able to measure liabilities reliably in all except extremely rare cases. They argue that the outcome of litigation—especially in the US—is often impossible to estimate reliably. Respondents suggest that:

(a) the Board should remove the words 'extremely rare' and acknowledge the frequency with which such situations will arise.

(b) the Board should provide guidance or illustrative examples. Situations in which a litigation liability might not be reliably measurable might include those in which:

   (i) the proceedings are unprecedented;

   (ii) the range of possible outcomes is large; or

   (iii) the distribution of possible outcomes is skewed and has a very long tail.

(c) that guidance should identify 'mass tort' litigation as one source of liabilities that might not be capable of being measured reliably. For long periods of time defendants have very little information: they cannot predict even the eventual number of claims, far less the validity of the claims or their likely outcome. Mass tort litigation is common in some sectors, such as the pharmaceutical sector.

5 COMMENTS ON DUE PROCESS

5.1 Re-exposure

5.1.1 Many respondents express a view that the Board should have re-exposed the whole standard—rather than just the measurement requirements—or should re-expose the whole standard in future. CL175 *IOSCO* (whose members were divided on whether the IASB should re-expose the proposals) suggests that the IASB should at least make a near-final draft of the IFRS available for an extended period of time.

5.1.2 The reasons that respondents give for requesting re-exposure of the whole standard are that:

(a) the proposed changes in the recognition criteria need further debate. They will require significant changes in practice and respondents strongly opposed them when they were exposed in 2005. The Board has neither fully addressed respondent concerns nor adequately explained its reasons for re-affirming the original proposals. The working draft was not accompanied by a Basis for Conclusions.

(b) the recognition and measurement proposals are interconnected. It is not possible to comment on the measurement guidance without considering all of the proposals.

(c) the piecemeal way in which information has been published has caused confusion about the exact nature of the proposals. The additional non-authoritative staff paper on litigation is insufficient to compensate for the lack of guidance and clarify in the working draft IFRS. Even now, some draft elements of the proposed standard (such as an updated basis for conclusions, transition requirements and consequential amendments) have not been published at all. Publishing the entire package, even for a short

period, would enable all concerned to give comments based on a clear understanding of the proposals in their entirety.

(d) significant time has elapsed since the Board published the 2005 exposure draft. There have been many developments since then, such as new IFRSs, changes in technology, business models, business law, regulation, corporate governance practices. Stakeholders should be given an opportunity to comment on the consistency of the proposals with, or implications of the proposals for, other current projects and on the adequacy of the guidance and disclosure requirements.

(e) a number of jurisdictions have adopted, or signaled an intention to adopt, IFRSs since the 2005 exposure draft. Stakeholders in these jurisdictions should have an opportunity to comment on the proposals. Further, the increasing focus on convergence with US GAAP means that some of the differences should be revisited.

(f) due process appears to have been condensed because of a desire to complete the project before the 2011 deadline and/or before Board members come to the ends of their terms. The project is not part of the Memorandum of Understanding so there is no need to progress it so urgently.

(g) a limited-scope exposure draft is a departure from the Board's normal due process procedures and risks damaging the Board's reputation.

5.1.3 Most of these respondents go on to give their views on aspects of the IFRS that the Board has not re-exposed. Overwhelmingly, they are concerned about the removal of the 'probable outflows' recognition criterion and the requirement to measure liabilities at expected value. These concerns are explained in Sections 3 and 4 above.

5.2 Other aspects of due process

5.2.1 A few respondents commented on other aspects of due process:

(a) three respondents think that the comment period (originally 3½ months, later extended to 4½ months) was too short because the exposure draft addressed a complex and contentious area the working draft of the entire IFRS was not available throughout the comment period, or six months should be the standard comment period for major projects, because of their number and the consultation processes required.

(b) two respondents note that six IASB members voted against the exposure draft and question whether it is appropriate for proposals to proceed with only nine votes.

(c) one respondent suggests that the Board should field-test the proposals.