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22 March 2010

Dear Stig

Exposure Draft: Measurement of Liabilities in IAS 37 (ED/2010/01)

I am responding on behalf of the Accounting Standards Board (ASB) to the draft comment letter on the International Accounting Standards Board's (IASB) Exposure Draft (ED) 'Measurement of Liabilities in IAS 37'.

I enclose a copy of the letter the ASB has sent to the IASB on the ED. As you will note the ASB agrees with the majority of the matters raised by EFRAG in its draft comment letter. The ASB does not, however, agree with EFRAG that liabilities in the scope of IAS 37 should be measured at the expected outflow of resources required to settle the liability. The ASB agrees with the IASB that liabilities should be measured by reference to the lowest alternative to settle the present obligation. The ASB notes that should an entity decide to settle at an amount above the lowest alternative then it should record this amount when it settles the liability.

Should you have any queries regarding our response please contact me or Michelle Sansom, Project Director, on 020 7492 2432 or by email m.sansom@frc-asb.org.uk.

Yours sincerely

Ian Mackintosh

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Joan Brown
International Accounting Standards Board
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22 March 2010

Dear Joan

Exposure Draft: Measurement of Liabilities in IAS 37 (ED/2010/01)

I am responding on behalf of the Accounting Standards Board (ASB) to the Exposure Draft (ED) 'Measurement of Liabilities in IAS 37'. The ASB has also taken this opportunity to comment on the proposals for recognition of liabilities as set out in the Working Draft of IAS 37 published on the IASB's website on 19 February 2010.

The ASB does not agree with the proposals in the ED nor those in the Working Draft; in its view the proposals will not lead to the production of decision useful information and consequently do not represent an improvement in financial reporting.

The ASB has formed this view for the following reasons:

(i) its previously stated views regarding the removal of the probability of outflows from the recognition criteria. The ASB is of the view that the removal of the probable outflow criteria[1] will make the standard more difficult to apply in practice. This is because a body of evidence will need to be established to address element uncertainty. The probability of an outflow is a useful criterion that, at a practical level, provides a screening test whereby entities often do not address element uncertainty because it is more likely than not that an outflow will occur;

(ii) the relevant outflows to be used to estimate a liability, where the liability will be fulfilled by undertaking a service, should not include a profit margin for the following reasons:

(a) the inclusion of a profit margin in the relevant future outflows is not consistent with the measurement objective because profit is an inflow to an entity. Therefore, where the entity undertakes the service itself, the profit margin is released back to profit and loss, there is no actual inflow or outflow;

[1] That is removal of paragraph 14(b) of IAS 37.

(b) inclusion of a profit margin, where the entity undertakes the service itself, does not provide decision useful information. The profit margin is merely charged to profit and loss when the liability is recognised and then later released back to profit and loss;

(c) not all of an entity's activities generate revenue. The ASB considers that all activities are necessary to generate shareholder wealth but that there is a distinction between revenue generating activities and profit improvement activities; and

(d) a measurement objective based on price may be less verifiable than one based on cost, as the ED proposes prices can be based on benchmark data.

(iii) the ASB agrees with the alternative view regarding the risk adjustment. The ASB considers that the ED lacks guidance on what the risk margin is and how it should be calculated.

The ASB is also concerned about the application of expected values in high impact/low probability scenarios (see paragraph 6 of Appendix One to this letter).

The ASB believes that the measurement proposals, similar to the recognition proposals, will not be well received. In the absence of support for both the recognition and measurement proposals and taking into consideration the IASB's divided views (as is evident with 6 IASB members offering an alternative view) the ASB is of the opinion that the IASB should defer the project until post 2011 when it should have more time available to undertake a fundamental rethink of its proposals.

Finally, the ASB notes the IASB decided not to re-expose the recognition proposals as part of the ED but to publish the Working Draft. Whilst it appreciates that the IASB has previously issued individual parts of a future IFRS for re-exposure, it does not consider such an approach was appropriate in this instance for the following reasons:

(i) significant time has elapsed since the June 2005 ED was published and as a consequence the original proposals are no longer familiar to constituents;

(ii) this lack of familiarity inhibits evaluation of the proposals for the measurement of liabilities without the revised guidance on recognition; and

(iii) the proposals will affect all entities and is not a topic that is limited to a few specialised sectors. It is therefore important that constituents are able to make a full evaluation of the proposals and are not hindered by a lack of information.

The ASB is of the opinion that should the IASB consider re-exposure in the future it should take the above matters into consideration.

The ASB has responded to the invitation to comment in the appendix to this letter.

Should you have any queries regarding our response please contact me or Michelle Sansom, Project Director, on 020 7492 2432 or by email m.sansom@frc-asb.org.uk.

Yours sincerely

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Appendix One: ASB response to Invitation to Comment

Question 1 – Overall Requirements

The proposed measurement requirements are set out in paragraphs 36A–36F. Paragraphs BC2–BC11 of the Basis for Conclusions explain the Board's reasons for these proposals.

Do you support the requirements proposed in paragraphs 36A–36F? If not, with which paragraphs do you disagree, and why?

1. The ASB does not support the overall requirements as proposed in paragraphs 36A to 36F. The ASB has considered the proposed requirements and makes the following comments:

Paragraph 36A

2. The ASB agrees that 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.

Paragraph 36B

3. The ASB agrees that an obligation should be measured by reference to the lowest alternative to settle the present obligation.

4. The ASB does not agree that where the obligation will be settled by fulfilment the present value of the resources should be measured by reference to the amounts that the entity would rationally pay a contractor at the future date to undertake the service on its behalf. The ASB has set out its views in the covering letter, as follows:

   (i) the inclusion of a profit margin in the relevant future outflows is not consistent with the measurement objective because profit is an inflow to an entity. Therefore, where the entity undertakes the service itself, the profit margin is released back to profit and loss, there is no actual inflow or outflow;

   (ii) inclusion of a profit margin, where the entity undertakes the service itself, does not provide decision useful information. The profit margin is merely charged to profit and loss when the liability is recognised and then later released back to profit and loss. In the ASB view this does not provide reliable performance information;

   (iii) not all of an entity's activities generate revenue. The ASB considers that all activities are necessary to generate shareholder wealth but that there is a distinction between revenue generating activities and profit improvement activities; therefore, profit should not be allocated to all activities;

(iv) a measurement objective based on price may be less verifiable than one based on cost, as the ED proposes prices can be based on benchmark data.

5. The ASB supports the alternative view set out in the ED and considers that an obligation that is fulfilled by undertaking a service should be measured at the expected incremental costs of fulfilling the obligation.

6. In relation to the use of expected values, the ASB considers that the expected value is a more objective measure than a best estimate of a liability. The ASB is, however, concerned about its application in high impact/low probability scenarios where often there are only two possible outcomes (win or lose). In these circumstances the ASB considers that providing disclosures about the possible outcomes and the nature of risk involved will provide more decision useful information than an expected value measure.

7. The ASB considers that the guidance provided in paragraph B4 on how to calculate the expected value is of limited assistance. The ASB interprets the guidance as stating that an entity does not have to prepare detailed calculations in all cases provided the outcome is within the expected range. A reasonableness test is difficult to apply when the outcome is unknown – some may argue that without preparing the detailed calculation it is unknown if the estimate is reasonable. The ASB considers that the guidance in this area should be developed further and specify appropriately the detail required.

8. The ASB also has concerns in relation to the requirement to take into consideration the risk that the actual outflows of resources might ultimately differ from those expected. The ASB notes that where the obligation is fulfilled the relevant outflows are based on the amount that the entity estimates a contractor would charge at a future date. The ASB does not consider that the ED clearly identifies that the risk adjustment is to take into consideration the potential estimation error from an entity using today's prices to estimate a future price.

9. As a consequence of the above, the ASB agrees with the alternative view set out in the ED that there is a lack of guidance as to the circumstance of when a risk adjustment should be included.

Paragraph 36C

10. See the drafting comments set out in Appendix Two.

Paragraph 36D

11. Paragraph 36D states the amount an entity would pay to cancel or transfer an obligation includes any cost of cancellation or transfer. This is expanded on in paragraph B7; where associated costs include external legal fees and in-house

legal costs. The Fair Value Measurement ED states, in paragraph 15, that the fair value of the asset or liability shall not be adjusted for costs. Whilst the ASB acknowledges that the Fair Value Measurement ED provides that transaction costs are accounted for in accordance with the relevant standard, it considers that the reason for including transactions costs in the measurement of liabilities in accordance with IAS 37 should be set out in the Basis for Conclusions.

12. Finally, the ASB notes that paragraph B7 permits the inclusion of in-house legal department costs attributable to the obligation. The ASB considers that only those costs that are incremental costs to the entity in settling the obligation should be included in the measurement of the liability. It therefore opposes the inclusion of allocated overheads in the measurement of a liability.

Question 2 – Obligations fulfilled by undertaking a service

Some obligations within the scope of IAS 37 will be fulfilled by undertaking a service at a future date. Paragraph B8 of Appendix B specifies how entities should measure the future outflows required to fulfil such obligations. It proposes that the relevant outflows are the amounts that the entity would rationally pay a contractor at the future date to undertake the service on its behalf.

Paragraphs BC19–BC22 of the Basis for Conclusions explain the Board's rationale for this proposal.

Do you support the proposal in paragraph B8? If not, why not?

13. No, the ASB does not support the proposal, for the reasons set out above.

Question 3 – Exception for onerous sales and insurance contracts

Paragraph B9 of Appendix B proposes a limited exception for onerous contracts arising from transactions within the scope of IAS 18 *Revenue* or IFRS 4 *Insurance Contracts*. The relevant future outflows would be the costs the entity expects to incur to fulfil its contractual obligations, rather than the amounts the entity would pay a contractor to fulfil them on its behalf.

Paragraphs BC23–BC27 of the Basis for Conclusions explain the reason for this exception.

Do you support the exception? If not, what would you propose instead and why?

14. The ASB does not support the measurement proposals in the ED and considers the proposed exception is a function of those requirements.

15. It is noted in the Basis for Conclusions that applying the requirements proposed in the ED would change the current practice for onerous contracts and, in view of the IASB's ongoing projects in this area, it does wish to change current practice. The ASB notes that were the IASB to change practice for these contracts then an entity would present a profit on the outflows required to settle the obligation. The ASB has already stated it does not agree that the relevant outflows should include a profit margin and considers this exception merely highlights the matters raised in the alternative view that the proposed accounting creates inappropriate performance information.

Appendix Two: ASB Drafting Comments

The ASB would like to offer the following drafting comments:

Paragraph 36A

1. The ASB considers that the measurement objective should be discussed in the Basis for Conclusions to the standard. The ASB is of the view that the measurement objective is an exit value based on the lowest amount an entity would settle the liability for. The Basis for Conclusions does not discuss the measurement objective but reiterates what is included in the draft standard and that the IASB is of the view the objective captures value-maximising behaviour. The ASB considers that greater discussion is required.

2. The ASB also considers that the ED does not clearly articulate if the objective requires entity specific inputs or market participants' inputs. In the ASB's view the inputs should be entity specific as this provides information on the relevant outflows and enables investors and other capital providers to assess the effect that an obligation has on the value of their claims to the entity's resources.

3. The ASB also considers that the Basis for Conclusions should discuss the relationship between the Board's proposals in the ED and its current proposals in relation to the Fair Value Measurement ED. In relation to the Fair Value Measurement ED the ASB notes that paragraph 28 provides that where an entity estimates the price that market participants would demand to assume the liability using present value techniques this produces the same price as to transfer the liability at the measurement date. That is, the Fair Value Measurement ED appears to argue that settlement and transfer are equal amounts; however, the proposals in relation to IAS 37 are based on a lower of alternatives.

Paragraph 36B

4. The ASB considers that guidance is required in relation to the IASB's views expressed in paragraph BC15(c) as to when a liability is so uncertain that it cannot be reliably measured. The ASB considers that the guidance should address whether it is the outcome from the use of expected value that does not provide decision useful information or whether a liability cannot be reliably measured when the expected outflows are not known, or both.

Paragraph 36C

5. The ASB suggests that the drafting of this paragraph could be improved:

   Where an entity cannot cancel or transfer an obligation within the scope of the standard it measures that present obligation at the present value of the resources required to fulfil the obligation. An entity provides reliable evidence that it cannot cancel or transfer the obligation.