Federation of European Accountants
Fédération des Experts comptables Européens

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Ref.: ACC/HvD/LF/ID

Dear Ms. Flores,

Re: FEE Comments on EFRAG's Draft Comment Letter on IASB Exposure Draft *Measurement of Liabilities in IAS 37*

(1) FEE (the Federation of European Accountants) is pleased to provide you below with its comments on the EFRAG Draft Comment Letter on the IASB Exposure Draft *Measurement of Liabilities in IAS 37* (the "ED").

(2) In general, we share the main concerns highlighted by EFRAG in its draft comment letter. Our major points of concern are summarised as follows:

Due process

(3) Like EFRAG, FEE regrets the lack of due process by the IASB with regard to this project. Stakeholders were not given an appropriate opportunity to evaluate the project given the scope of the material being re-exposed and the time allowed for comments.

(4) We also believe that the IASB should have re-exposed the entire proposed standard in order to give the stakeholders the ability to properly evaluate the measurement principles in the context of the standard as a whole (i.e. in the context of the liabilities that will be recognised using the revised recognition principles).

(5) A truly transparent process would have required the Board to include in the working draft the Basis of Conclusions that it is proposing to include in the final standard, setting out the reasons why the serious concerns expressed on the original ED were not acted upon as well as an explanation as to why the Board considers that the significant changes to IAS 37 will result in an improvement to financial reporting.

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(6) Given that the original exposure draft was considered highly controversial, it would be appropriate to give stakeholders the opportunity to consider the arguments set out by the Board to justify going ahead with the proposals.

(7) In the absence of any justification by the Board in the form of a Basis of Conclusions setting out why IAS 37 is being changed at this time, we strongly agree with EFRAG that a change in IAS 37 is not justified.

(8) In addition, the proposals in the ED provide for only a limited re-exposure of parts of the earlier exposure draft. In our opinion, the issues on which the Board seeks comment cannot be evaluated in isolation from the other elements of the planned standard. Indeed, we do not believe that it is appropriate to request comments only on certain aspects of the measurement principles proposed. This is why our response provides also comments on other aspects of those principles.

(9) Moreover, we believe that the five year gap between the earlier exposure draft and the current ED justifies a full re-exposure of the planned standard, particularly in the light of the significant developments in other standards (completed and proposed) which are directly linked to the way liabilities are measured and recognised.

(10) We agree with EFRAG that the proposals in this project may have a significant impact on other projects such as the standard on insurance contracts. Therefore, we consider that it is important that allowance is made for a more comprehensive debate before decisions are made.

Definition of a liability

(11) We believe that the removal of the probability criterion is a fundamental change in the recognition principles applicable to liabilities. As a result, the principles establishing when a liability is recognised in the new IAS 37 are not coherent with those currently established in the IASB framework. Regardless of our disagreement with the proposed approach, as explained below, we strongly believe that the introduction of a significant change affecting the recognition principles of a liability would be more appropriately addressed as part of the current overall review of the Conceptual Framework, rather than through a revision of any individual standard.

(12) Furthermore, we do not believe that the removal of the probability criterion is an improvement to financial reporting since it would result in recognition of liabilities even though outflows of resources are not probable. Users are better served with information that is predictive of the future cash flows of an entity. Accordingly, for obligations for which cash outflows are not probable, we believe that more useful information can be provided via note disclosures than by recognition of the highly uncertain estimate that would result from the application of the expected value model proposed in the ED.

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(13) We are aware that some Board members have indicated that, in their personal views, the removal of the probability criterion should have minimal impact because the concept of probability is inherent to the determination of whether a present obligation exists. If this also represents the Board's official position, then significant redrafting is required to clarify this principle since it cannot be inferred from the current wording of the working draft.

Applying the expected value

(14) Like EFRAG, we believe that the expected value technique, based on a probability-weighted average, as described in B2-B4 is best suited to value liabilities in cases where there are large homogeneous populations of items to support the measurement of the present value of the resources required to fulfil an obligation. To the contrary, we believe that a measurement based on the most likely outcome, along with appropriate disclosures, provides more decision-useful information to the users of financial statements in the case of a single liability.

Including a risk adjustment

(15) The proposals to include a risk adjustment do not provide a clear explanation of what this risk adjustment is meant to capture and how it would be determined in practice. Indeed, considering that the risk adjustment proposed in the ED is a component of the price the entity would pay to fulfil the obligation, including a risk adjustment is akin to including remuneration for an entity's own uncertainty in the measurement of the obligation. While this remuneration can be understood, conceptually, in determining a transfer value, it is not clear why such an adjustment would be necessary (or appropriate) in establishing a fulfilment value.

(16) Furthermore, as noted by EFRAG, the ED provides insufficient information on the circumstances when the adjustment would be necessary or how it would be measured. Like EFRAG, FEE is concerned that the lack of guidance would result in generic unsupported adjustments or significant diversity in practice.

(17) Accordingly, until the IASB is able to demonstrate convincingly why a risk adjustment is necessary as part of the fulfilment value and is able to develop a reliable estimate of this adjustment in practice, FEE is unable to comment on the appropriateness of this proposal.

Including a profit margin

(18) Like EFRAG, we disagree with the proposal that the measurement of an obligation that will be fulfilled by services to be undertaken by the entity itself should include a profit margin. The inclusion of this profit margin does not contribute to a prediction of future cash flows.

Our responses to the questions in the Invitation to comment section of the ED, made in the context of our concerns outlined above, are included as an Appendix to this letter.

For further information on this letter, please contact Leyre Fuertes, Project Manager.

Yours sincerely,

Hans van Damme
President

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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?

Measurement objective

(19) BC9 notes the proposal that an entity should 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. It then notes that this amount "is the lowest" of three alternatives depending on whether the obligation is fulfilled, cancelled or transferred to a third party.

(20) We do not share entirely EFRAG's view that an obligation may be measured at an amount that does not reflect the lowest amount that an entity would pay to be relieved of the obligation. If an entity opts to be relieved of an obligation for a higher amount, the excess amount should be recognised in the period it is incurred.

(21) Nevertheless, we believe that this discussion is highly theoretical since in many cases an entity might be unable to cancel or transfer an obligation. We can question the added benefit gained from trying to assess whether, and at what amount, an entity could cancel or transfer non-routine obligations when is uncertain that such actions are possible. Hence, we suggest that the fact that the most rational choice will be the lowest amount should be presented as a rebuttable presumption rather than as a requirement.

Applying the expected value

Question to constituents
What are constituents' views on the use of expected value?

(22) Similar to EFRAG, we disagree that the expected value technique based on a probability-weighted average described in B2-B4 should be used in cases other than large populations of items to measure the present value of the resources required to fulfil an obligation. In particular, we believe that a measurement based on the most likely outcome, along with appropriate disclosure, provides more decision-useful information to the users of financial statements in the case of a single liability since it results in an amount that is indicative of a possible outcome and accordingly gives a better prediction of future cash flows. In this respect, we believe that the current requirements of IAS 37 are superior.

(23) Conceptually, the proposed expected value approach is acceptable in the case of a large portfolio of individual liabilities. However, in the case of a single liability, the outcome of accounting for them using an expected value approach would conceptually be less reliable. In case of a small population of items, the accuracy produced by the weighted-probability approach is deceptive; it implies an ability to attach accurate probabilities to highly uncertain scenarios.

(24) In addition, it might not always be possible in practice for entities to obtain the information required to perform a probability-weighted expected approach. Collecting the necessary data could be excessively costly and complex. Generally, entities have systems in place to collect the necessary information to develop reliable multiple probabilistic scenarios only when they are routinely dealing with large portfolios.

Including a risk adjustment

(25) The proposals to include a risk adjustment do not provide a clear and convincing explanation of what this risk adjustment is meant to capture and how it would be determined in practice (see also our comments in paragraphs 15-17 of this letter). Accordingly, at this time, FEE is unable to comment on the appropriateness of this proposal.

(26) In any case, it appears that the risk adjustment is aimed at achieving a degree of accuracy in measuring the obligation that is not achievable in most cases.

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?

(27) Like EFRAG, we disagree with the proposal that the measurement of an obligation that will be fulfilled by services to be undertaken by the entity itself should include a profit margin. The inclusion of this profit margin does not provide information that allows users of the financial statements to predict future cash flows.

(28) In particular, we support the alternative view explained in AV2, that if an entity expects to fulfil an obligation by undertaking a service itself, the proposal to include a profit margin results in misleading performance information for users as it does not represent a real outflow of the entity's resources. We do not think that including it in the value of the obligation would provide decision-useful information.

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(29) Accordingly, FEE strongly believes that a cost-based measurement, such as the current requirement of IAS 37, provides more relevant information to users about the expected cash flows that the entity will incur in the fulfilling its obligations.

(30) In our view, there is a need for greater clarity on how an entity would be able to arrive at the estimation of the value of the services in the absence of a market for the service.

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?

Questions to constituents

Do you agree with the view expressed in relation to the proposed exception for the measurement of onerous contracts?

Are there other aspects of the proposals in the ED that constituents believe it would be appropriate to address?

(31) We support the exception proposed for onerous sales and insurance contracts.

(32) In fact, we believe that the exception should extend to all obligations related to contracts in the scope of IAS 18 that are currently within the scope of IAS 37. The reason given in BC27 to support the exception for onerous contracts is equally valid to all obligations currently in the scope of IAS 37 that may be scoped in IAS 18 when the revisions to this standard are finalised.

(33) In line with the comments expressed elsewhere in this letter, we believe that all obligations should be measured by reference to the relevant future outflows which should be the costs the entity expects to incur to fulfil its obligations. On that basis, we believe that the measurement of all onerous contracts should be cost-based rather than value-based.

(34) In addition, the fact that it appears necessary to include a scope exemption may indicate that there is a problem with the underlying principles in the ED. In particular, it indicates that the measurement principle for obligations within the scope of the revised IAS 37 may differ from the principle that will be established as part of the new revenue and insurance standards for similar obligations. This is one more reason why FEE concludes that it would be more judicious to postpone completion of the project on liabilities.