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24 March 2010 By fax: 2865 6776 & by post

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Wanchai
Hong Kong

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Dear Mr. Ong

IASB Exposure Draft – Measurement of Liabilities in IAS37 ("ED") issued by Hong Kong Institute of Certified Public Accountants ("Institute")

We refer to your letter dated 12 January 2010 and would like to set out below our comments on the above ED for your consideration.

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?

Our reply: -

We do not support the requirements proposed in paragraphs 36A to 36F.

Under the Framework, a liability is recognised when it is *probable* that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably. We are concerned that the proposed measurement of a liability using the expected value would introduce a fundamental change which is inconsistent with the recognition criteria in the Framework. We note that BC10 states that in the Board's view, the proposals in paragraph 36B clarifies existing guidance in IAS 37. We are concerned that this assertion, if it appears in the new standard, will have the effect of

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秘書 廖碧瑩

Incorporated by Ordinance, Cap. 364
根據條例第364章成立

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requiring entities to apply the measurement rules in Appendix B when they are still using the existing version of IAS 37.

We are not convinced that the proposed measurement approach would provide information that is more decision-useful than that provided under the current 'most likely outcome' approach. We do consider that the proximity of the estimate of a liability to the actual cash flow subsequently required to settle is information that is relevant to the decision making of both investors and company management. We are not convinced that the following assertion set out in BC3(a), which plays an important role in supporting the proposed measurement approach, is always true.

> *BC3(a) '...Rationally, an entity would pay an amount that is not based solely on the most likely outcome. Rather, it would pay an amount that reflects the probability-weighted average of all possible outcomes...'*

The "expected value of future outflows" proposed under the ED will not always generate a meaningful measurement of a liability and may not be an amount that the entity will have to pay. For example, if there is a litigation claim against the entity and it is considered improbable that the entity will have to pay under the claim, under the proposed ED, a provision would still be required unless the probability of payment was nil. This does not make sense because the entity is required to assign probabilities to unlikely outcomes. In addition, assigning probabilities to unlikely outcomes is very subjective. Furthermore, from a practical perspective, this would require additional resources to calculate these subjective probabilities.

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 fulfill 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?

Our reply: -

We do not support the Board's proposal. We agree with the alternative view presented in the ED in that making a provision based on the price that a third party would demand for providing the service to meet the obligation is not necessary appropriate if the company intends to provide the service itself as any margin that a third party would charge for providing the service would not need to be paid. The alternative view is consistent with the definition of a liability in the Framework which states that the settlement of a

liability is expected to result in an outflow from the entity of resources embodying economic benefits. Under the situation mentioned above, the outflow from the entity is not expected to include a profit margin when the service is provided by the company itself.

Including a profit margin is also potentially misleading to readers of the accounts who may misinterpret the provision as the entity's potential cash outflow. In addition, there may not always be an active market for the required services and this would result in the entity having to estimate a reasonable profit margin.

Rather than imposing a required profit margin into the calculation of the market price of the service to be provided, it would be more useful if the accounting standard provided guidance on the costs that should be included when calculating the liability and only require a profit margin to be included if the service was to be provided by a third party.

It is also not clear what is meant by the proposed "risk" adjustment for the computation of the present value of the resources required to fulfill an obligation and how this risk adjustment should be determined. It is also likely that adding a risk adjustment to the calculation of the liability will increase its subjectivity.

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 fulfill its contractual obligations, rather than the amounts the entity would pay a contractor to fulfill 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?

Our reply: -

We support the exception as we consider that profit margins should not be considered when the company has the intention to delivery the service itself.

Other comments

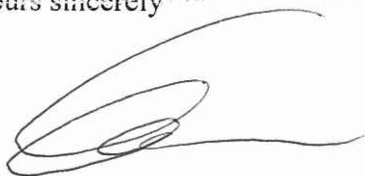
1. Appendix B19 on subsequent remeasurement states that "It is important not only that estimates faithfully represent conditions at the end of the reporting period, but also that estimates faithfully represent changes in conditions during the period." With respect to this, we note that changes in estimates do not necessarily always arise from changes in conditions during the period. This is particularly relevant in

the case of legal claims where it is possible for the estimate of a liability to change in circumstances when there has been no development in the case or settlement discussions, but at the last reporting date such developments had been expected.

2. BC15(a) discusses the meaning of 'reliability' and follows on to state that the measurement objective is to measure the liability at the end of the reporting period and to depict the uncertainties at that date, not to predict the entity's future outflows. It is not obvious from the Board's argument as to how the proposed probability-weighted average approach can depict uncertainties at the reporting date and how it will render the estimate of a liability more reliable than that derived under the current 'most likely outcome' approach.

We would be happy to further clarify or discuss any of the above points should you so wish.

Yours sincerely



Rita Liu
Secretary