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Mr. Steve Ong
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Hong Kong Institute of Certified Public Accountants
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Dear Steve,

IASB Exposure Draft on Measurement of Liabilities in IAS 37 (Limited re-exposure of proposed amendment to IAS 37) ("Exposure Draft")

I refer to your letter dated 12 January 2010 on the above to our Mr. Mark Dickens which has been passed to me for my attention.

We have completed our review of the Exposure Draft and our views are set out in the paragraphs below.

General

The Exposure Draft sets out proposals for the measurement of liabilities in the scope of IAS 37 – Provisions, Contingent Liabilities and Contingent Assets.

IASB issued an exposure draft on proposed amendments to IAS 37 in 2005 (the "2005 Exposure Draft") and the current Exposure Draft proposes to add guidance on how liabilities should be measured. IASB decided not to re-expose the full text of the new standard and invites comments only on the new measurement guidance proposed in the Exposure Draft.

We disagree with the IASB's decision to a limited re-exposure as the 2005 Exposure Draft proposed fundamental changes in the recognition and measurement of liabilities which is a Conceptual Framework issue and should be included in the project on reviewing the Conceptual Framework. The consequences of the proposed changes are far-reaching.

Our detailed comments are discussed further below.

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Re-exposure of the new standard in full

IASB proposed in the 2005 Exposure Draft a number of fundamental changes in the recognition and measurement of liabilities, including removal of the probability recognition criterion and to measure liabilities at their "expected values", i.e., the probability-weighted average of the outflows for the full range of possible outcomes. Many respondents raised concerns and expressed their criticisms on the 2005 Exposure Draft but we note that IASB has decided not to re-expose the full text of the proposed standard. We do not agree with this decision as readers will not fully understand the implications of the changes made.

Though BC5 to BC8 and BC12 to BC18 in the Exposure Draft provide some feedback on comments received in respect of "expected values" in response to the 2005 Exposure Draft, we believe that IASB has not yet adequately addressed the concerns of respondents. The proposed fundamental change in the recognition and measurement of liabilities require further in-depth discussion. In addition, a number of changes to the 2005 Exposure Draft were identified in an IASB staff summary of the tentative decisions that IASB has reached arising from the comments received to the consultation in 2005. Accordingly, we believe that re-exposure of the new standard in full and thorough discussion of the proposals is necessary.

Present obligation vs. future commitment

We believe that it is vital to distinguish a "present obligation", that is, a "liability" from a future commitment or obligation which may not necessarily result in the outflow of resources. Under the current Conceptual Framework only liabilities are recognised in financial statements. Commitments or future responsibilities to make cash outflows are not recognised but are only disclosed. We have similar concerns on this Exposure Draft as the concerns we had when we commented on IASB's discussion paper on its proposals on lease accounting. We believe that when the Framework was developed the word "present" was intentionally added to distinguish present obligations from future obligations and commitments. Paragraph 61 of the Framework stresses and draws a distinction between a present obligation and a future commitment.

We also note that IASB has recently released a working draft dated 19 February 2010 of a proposed new standard on liabilities (the "Working Draft"). We understand that changes proposed to IAS 37 on liabilities measurement will be moved to the new standard on liabilities. We note that the proposed new standard intends to cover all liabilities except those whose treatment is specified by another IFRS. Paragraph 4 of the Working Draft provides some examples of the liabilities that are within the scope of the revised IAS 37 and the proposed new liability standard and include the following:-

(a) obligations to decommission plant and equipment;

(b) environmental restoration and rehabilitation obligations;

(c) legal or regulatory claims against the entity;

(d) onerous contracts, whose treatment is not specified by another IFRS.

We consider the examples given are essentially only "commitments" to act and pay amounts in the future and are not "present obligations" that qualify for recognition as liabilities.

"Liabilities" or present obligations should be distinguished from mere "obligations", which under paragraph 60 of the Framework are described as "a duty or a responsibility to act or perform in a certain way". We believe that the inclusion of the word "present" before the word "obligation" attempts to indicate that it is necessary to consider the timing of an obligation in the assessment of whether a liability exists; that is, an obligation may be established in the past, the present or the future. We believe that an obligation is merely a "deliverable. It may or only becomes a present obligation when the duty to act is "delivered", either due to the occurrence of an event or condition, or the passage of time that represents the meeting of the agreed term(s) of the transaction previously agreed between the contracting parties. We believe only obligations that have become present obligations should be recognised. Future obligations should not be recognised or only recognised in limited circumstances as explained under "provisions" below. Material future obligations should be disclosed.

We believe that the IASB in its analysis and discussion of liabilities should therefore clearly and fully explain its interpretation of "present obligation" and also provide illustrative examples. In this respect, the examples provided should be explained from both a seller's and a buyer's perspective, and should cover both the exchange of goods as well as the provision of services so that the conclusion reached is conceptually sound and acceptable.

For example, we believe that in the case of an obligation contracted in Year 1 to restore a forest after the excavation of coal in a mining operation which is expected to last for say ten years, although the obligation to act is contracted in Year 1, the obligation to restore is not an immediate or present obligation. The mining company is obliged to restore the environment but the duty or responsibility to undertake the restoration only becomes a "present" obligation when the mining company ceases mining in Year 10. Similarly, the signing of a guarantee creates a legal obligation and a "deliverable" but a present obligation will only arise when the obligation to pay is triggered or is "delivered" when the original debtor fails to pay. If the original debtor repays the creditor, a present obligation or the need to make an outflow of resources by the guarantor is not created.

We believe that the issue of making "provisions" is a separate issue from determining the existence of a "liability". We believe a "provision" in substance is not a "liability" and the current accounting literature mixes the two. Currently, under IAS 37 the standard defines a provision as "liabilities of uncertain timing or amount". Paragraph 14 of IAS 37 also says a provision should be recognised when and only when:-

"(a) an entity has a present obligation (legal or constructive) as a result of a past event;

(b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and

(c) a reliable estimate can be made of the amount of the obligation."

We believe that the guidance is confusing. We believe that if criteria (a) above is met, that is, there is a present obligation, this fact alone means that a liability exists and if this is the case we believe the liability should be recognised even if there are difficulties in measurement. If there are difficulties in measurement how the amount was determined should be disclosed so that readers understand that the amount is an estimate and the degree of reliance that can be placed on it.

The existence of a present obligation by definition means that there is a liability and there should and <u>will</u> be an outflow of resources. There is no issue concerning whether there will be a <u>probability</u> of the outflow of resources, as this is a given.

Currently, an example of a provision in IAS 37 (see Example 10) is the expected costs in a legal case which is being heard by the court. The analysis provided is that whether a "present obligation" exists depends on the lawyer's advice on whether it is <u>probable</u> that the entity will be found liable, rather than the fact that it is in fact liable. It then goes on to explain that because the outflow of economic resources is "probable" a provision for settling the legal case should be made. We believe the example is inconsistent with paragraph 14 of IAS 37 as a present obligation has not been established but merely the probability that the entity <u>will be</u> found liable. We therefore believe it is necessary for the IASB to clearly distinguish "provisions" from "liabilities" and to fully explain the differences.

We believe the original intention for "provisions" was to allow the early recognition of "future liabilities" prior to the establishment that a "liability" exists, that is, a "present obligation". We believe that the recognition of "provisions" is an implementation of the "prudence concept" of the Conceptual Framework which attempts to ensure that assets or income are not overstated and liabilities not understated. We believe "provisions" should continue to be allowed but only in restricted circumstances. To clearly distinguish "provisions" from "liabilities" we would suggest that guidance should indicate what they mean. We believe that "provisions" represent early recognition of future obligations that

have a high probability of crystallization in the near future as a liability. The current definition of "provisions" in IAS 37 should be reconsidered.

Removal of "probability of outflows" from criteria for recognition of liabilities

IASB proposes to remove the "probability of outflows" criteria from the recognition of a liability. We agree with the proposal as by definition, the existence of a liability means that outflows are certain. There is no question of the "probability of outflows". We believe "probability of outflows" deals with considerations concerning the timing of when the liability will be settled or extinguished. This is separate from the determination of whether a liability exists or its creation. In other words, a liability must exist in the first place before one considers how and when it will be settled.

To illustrate the above, if the party from whom an amount is received agrees to immediately waive or forfeit its right to repayment, the amount should be recognised as a gift or income rather than a liability. However, if the amount is to be returned and the obligation is not immediately waived a liability should be recognised as there is an obligation to repay. Future outflows are certain but the timing of outflows depends on the credit period granted by the creditor. Subsequently, if the creditor on a future date decides to waive or forfeit its right, the liability is effectively extinguished and the amount should be recognised as a gift or income.

Expected present values

Currently paragraph 36 of IAS 37 requires a provision to be measured at the *"best estimate of the expenditure required to settle the present obligation at end of the reporting period"*. IASB proposes in the Exposure Draft that a liability should be measured at the amount that an entity would *"rationally pay at the end of the reporting period to be relieved of the present obligation"*. We understand the term "rationally pay" is proposed to replace the term "best estimate".

Paragraph 36A of the Exposure Draft states that for initial measurement *"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."* We believe that what the entity will pay "at the end of the reporting period" would not be an appropriate measure for initial recognition. It should be the amount due at the time of creation of the liability.

Paragraph 36B of the Exposure Draft also proposes to require a liability to be measured at the lowest of the present value of the resources required to fulfill the obligation and the amount that the entity would have to pay to cancel or transfer the obligation to a third party. Paragraph B3 explains that the expected present value is the *"probability-weighted average of the present values of the outflows for the possible outcomes"*.

We accept the observation that the term "best estimate" may be currently interpreted differently by preparers of financial statements. However, we believe that the term "best estimate" is better understood by preparers than the proposed new term "rationally pay". We would suggest that a preferred approach is to provide additional guidance on what should be considered when preparers determine their "best estimate"; for instance, the guidance should cover what costs should be included or excluded, and the guidance should include illustrative examples.

We do not support the proposed measurement of liabilities at their expected present values, i.e., the probability-weighted average of the present values of the outflows for all possible outcomes. We consider that this approach, which conceptually requires identification of all possible outcomes and allocation of probabilities to each possible income, is complex and costly. Paragraph B4 in the Exposure Draft attempts to provide some guidance. It states that *"Even if there is evidence to support many outcomes, it is not always necessary to consider distributions of literally all possible outcomes using complex models and techniques. Rather, a limited number of discrete outcomes and probabilities can often provide a reasonable estimate of the distribution of possible outcomes."* It therefore allows an entity to "select" some "discrete outcomes" but does not explain or provide any guidance on how to "select" the discrete outcomes. We consider that the guidance in paragraph B4 is confusing and is inconsistent with the intent described in the first bullet point in page 6 of the Exposure Draft, namely *"... the Board believes it is a relevant measure for capital providers, who would consider all possible outcomes and their relative probabilities when assessing the effect of a liability on the value of their claims to the entity's resources"*. To meet this intent, there would be a need to disclose to readers the full details of the outcomes and probabilities and not just the amount so determined.

The ultimate objective, we believe, is to determine the "best estimate" or quantification of the amount due and there will always be judgement involved in determining the answer. There will be no judgement required if the amount due is clearly and specifically quantified and agreed between the contracting parties from the outset. We consider that the proposed approach of allocation of probabilities to each possible outcome will be necessarily arbitrary. The illustrative example in pages 35 and 36 of the Exposure Draft includes a calculation of the probability weighted average amount. It clearly shows that the proposed approach will involve arbitrary allocation of probabilities to each selected outcome.

In summary, in our view, the proposals to adopt a probability-weighted average approach would only add a burden to preparers and would not provide more reliable and meaningful information. A simpler approach would be to retain the "best estimate" approach and to provide guidance on how it should be made and on the need for preparers to document and retain evidence of how it was determined.

Risk adjustment

Paragraph B15 in the Exposure Draft requires an entity to consider the risk that the actual outflows of resources might ultimately differ from those expected and include a risk adjustment in the measurement of a liability that the entity would rationally pay in excess of the expected present value of the outflows to be relieved of this risk.

Page 37 of the Exposure Draft includes an example of this risk which is in connection with employing a contractor to dismantle an oil rig. We believe that the quoted prices from the contractors included in the example already includes such risk and this risk is already taken into account in determining the expected present value of outflows. This is in fact illustrated in the example included in pages 36 and 37 of the Exposure Draft. A risk adjustment for price changes of CU6,622 is made on page 37, yet in page 36 it shows that there are various quotes obtained from contractors ranging from CU200,000 to CU340,000. We believe that these various prices must be the different quotes for the work to be done at the end of rig's life and includes a buffer for price changes.

Therefore, we suggest that IASB should further explain and clarify what the risk adjustment is intended to represent and whether there has been double-counting of the risk in the example.

Alternative views on the Exposure Draft

We note in page 17 of the Exposure Draft that the Exposure Draft was approved for publication by only nine of the fifteen Board members, i.e., 60%. Alternative views on the Exposure Draft from the remaining six dissenting members were provided in pages 31 to 35 of the Exposure Draft. We question whether a 60% majority of the Board is adequate to proceed with a proposed standard. We would therefore suggest that IASB should re-consider the appropriateness of its existing approval mechanism. We believe that there should be "substantial" agreement by board members before a standard can be approved for publication and 75% and above would be more representative of substantial agreement. We believe that the dissenting board members have legitimate concerns and we concur with their observation that looking at an external contractor's price will include a profit element and this will result in the overstatement of liabilities.

Conceptual issues

As mentioned above, we believe that the IASB should re-consider the meaning of liabilities under the Conceptual Framework project. The substance of the current proposals is to change the meaning of a liability and to require liabilities be re-measured at their fair values. However, we believe that re-measurement of liabilities does not

necessarily provide useful information and in fact may result in production of misleading information.

We believe the general principle should be that liabilities should represent and be measured at the amount that reflect the obligation agreed between the two contracting parties. The time value of money is agreed at the outset and is reflected in the interest payable and credit period given relating to the amount owed or is factored into the pricing. We believe that in most circumstances obligations are easily quantified and a specific amount is agreed at the outset between the debtor and creditor. It is only when a transaction is of a non-monetary nature or the obligation amount is agreed to be variable that there is a need to exercise judgement to determine the "best estimate" of the value to be placed on the obligation.

We also note that the current proposals on re-measurement of liabilities are made purely from the perspective of the debtor; that is, what the debtor will "rationally pay". However, we believe that in commercial reality the perspective of the creditor is more relevant. Whether satisfactory settlement of a liability has been made after the creation of the liability will be determined principally or solely by the creditor. For example, although a debtor may wish to sell his liability to another party, it usually can only do so if the creditor agrees. The creditor would consider the counter-party risk of the proposed new debtor. From the perspective of the creditor, his right and interest is to receive in full the face amount of the obligation when the liability was created and in accordance with the terms agreed with the debtor. The perceived present value of the liability as determined by the debtor at the debtor's reporting date is not relevant. We therefore believe that in developing guidance on liabilities, the IASB should clarify and explain the following:-

- What is an obligation?
- When is an obligation created?
- What is a <u>present</u> obligation? / What is a liability?
- When is a <u>present</u> obligation created?
- When is a <u>present</u> obligation settled?
- Can a <u>present</u> obligation be varied, and, if so, by whom?
- Does a variation in a <u>present</u> obligation represent the immediate settlement of the present obligation and the creation of a new present obligation or the creation of a new future obligation that may become a new present obligation in the future?

To illustrate the above, consider the case of an employer who hires a person on a three-year employment contract with a monthly salary of HK$50,000 which will be paid at the end of each month. The contract allows three months notice by either side for termination. The question is whether the employment contract represents an obligation. Is it one obligation to pay the salary for all three years or does it represent a duty to pay a series of 36 future obligations to pay the monthly salary at each month end during the coming three years but only if employee turns up to work? There is an obligation but we would

ask what is the present obligation. Is the present obligation the one obligation to pay the salary for all three years and should the amount for the entire three years be recognised as a liability on the date on which the employment contract was entered into? If so, what is the corresponding entry? Should it be a deferred asset or expensed? Or does a present obligation of the employer only arise after the staff provides the service and an amount representing one month's salary should be recognised as a liability at month end? If in Year 2, the employer decides to increase the person's salary to HK$55,000 per month how would you account for the change? Is the variation a change of the previous obligations/present obligations and are the previous obligations settled? Does it create new obligations/new present obligations? The above is for a very simple contract but what would be the answers if the employment contract was for continuous employment rather a fixed three-year term?

We believe that the above and other conceptual questions raised by respondents should be studied under the Conceptual Framework project, together with the practical implications, before the IASB finalizes its views on liabilities and prior to considering issues on measurement and re-measurement of liabilities.

We hope that the above comments are helpful.

Yours sincerely,
For and on behalf of
The Stock Exchange of Hong Kong Limited

Colin Chau
Senior Vice President
Listing Division

CC/el

c.c. Mr. Mark Dickens – Head of Listing