CPA
Hong Kong Institute of
Certified Public Accountants
香港會計師公會

Our Ref.: C/FRSC

Sent electronically through the IASB Website (www.iasb.org)

19 May 2010

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sirs,

IASB Exposure Draft on *Measurement of Liabilities in IAS 37*

The Hong Kong Institute of Certified Public Accountants is the only body authorised by law to promulgate financial reporting, auditing and ethical standards for professional accountants in Hong Kong. We welcome the opportunity to provide you with our comments on the captioned Exposure Draft (ED). Our responses to the questions raised in your ED are set out in the Appendix for your consideration.

We note that the IASB has decided not to re-expose in full the original 2005 ED of proposed amendments to IAS 37 but now requires comments only on the expanded measurement requirements. We disagree with this decision because the proposals of the original ED introduce fundamental changes to the recognition and measurement of liabilities, which were not well supported by many respondents to the original ED. Taking into consideration the IASB's divided views (as is evident with six IASB members offering an alternative view), we consider a debate on changes to the concept of a liability would be more appropriate as part of the Conceptual Framework Project, rather than this piecemeal approach. Although the IASB released a working draft of the entire Standard in late February 2010, it did not invite comments on this document. In light of the significant period of time that has elapsed since the original ED was issued, and the significant debate around the changes in recognition criteria arising from the earlier ED, we are not supportive of condensing due process in what appears to be an attempt to complete these amendments prior to June 2011. Instead, we believe that a full re-exposure of the document would have been more appropriate, particularly since it is considered difficult to comment separately on the measurement components without considering the recognition proposal in the draft Standard.

We agree that there are several areas in IAS 37 where the application of principles may be unclear. However, we are not persuaded that the application of the current measurement guidance creates significant problems for preparers and users of financial statements. Also, we do not think that the Board's proposal of using a probability-weighted average of the cash outflows for all possible outcomes for all provisions will improve financial reporting. This will be most notable for provisions for items which are unique in their characteristics or occur infrequently. In particular, we do not believe that the resulting measurement is meaningful when an entity faces an obligation where the outcomes are at extremes (for example, one of the possible outcomes is a low-probability, high-outflow scenario) or where the outcomes are binary, as a probability-weighted expected value approach in such circumstances will lead to a measurement that does not reflect the best estimate of the amount that management

37th Floor, Wu Chung House,
213 Queen's Road East, Wanchai, Hong Kong
香港灣仔皇后大道東213號胡忠大廈37樓
Tel電話: (852) 2287 7228
Fax傳真: (852) 2865 6776
(852) 2865 6603
Website網址: www.hkicpa.org.hk
Email電郵: hkicpa@hkicpa.org.hk

expects to pay to settle the obligation. We are also concerned that the proposals could be interpreted as including those outcomes that are inconsistent with the assertion that a present obligation exists, for example the outcome that would arise if a company were to unexpectedly win a law suit in which it is the defendant. In our prior comment letter dated 3 November 2005, we also expressed our concern about the practical implications of the new approach.

Furthermore, in respect of the ED, we disagree with the proposals to include:

- a risk adjustment in the measurement of a liability; and
- a profit margin in the measurement of a liability when the company intends to fulfil a service obligation from its own resources

Please refer to our response in Question 1 (Overall requirements) and Question 2 (Obligations fulfilled by undertaking a service) for more details.

If you have any questions on our comments, please do not hesitate to contact me at ong@hkicpa.org.hk.

Yours faithfully,

Steve Ong, FCPA, FCA
Director, Standard Setting Department

SO/WC/zc

Encl.

Hong Kong Institute of CPAs

IASB Exposure Draft on *Measurement of Liabilities in IAS 37*

<u>Question 1 – Overall requirements</u>

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?

As mentioned in our cover letter, we have significant concerns with the proposals in the ED:

<u>Measurement objective</u>

Paragraph 36A of the draft standard states that for <u>initial</u> measurement "an entity should measure a liability at the amount that it would rationally pay at the <u>end</u> of the reporting period to be relieved of the present obligation." In terms of definition, 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. In terms of application, it appears from the proposal that the measurement of non-financial liabilities in the ED moves from "best estimate" towards what could be characterised as a "fair value" approach. We believe that there is substantial uncertainty as to how the measurement of non-financial liabilities can be made reliably at fair value and at what degree fair value is more relevant for the measurement of all liabilities.

We agree that expected value is an appropriate measure for liabilities where the population is large and homogeneous (for example warranty obligations) because entities usually have an established practice of measurement using experience and statistical methods.

However, for many non-financial liabilities (especially those arising from legal disputes), evidence of the distribution of outcomes will often be unavailable. Therefore the measurement of such liabilities based on probability-weighted possible outcomes is subjected to inherent subjectivity and unreliability. We therefore do not think that the Board's proposal of using a probability-weighted average of the outflows for all possible outcomes for all provisions will improve financial reporting.

As set out in our covering letter, this will be most notable for provisions for items that are unique in their characteristics, occur infrequently or have binary outcomes. We do not believe that the probability-weighted expected value approach is always more relevant than amounts management has predicted it will most likely need to pay to extinguish those liabilities if they crystallise.

If the IASB does finalise these proposals, we also have concerns relating to the application of the probability-weighted outcome approach in situations where management is not 100% certain that the entity has a present obligation. We support the use of judgment in determining whether or not to *recognise* a provision in such uncertain circumstances. However, we have concerns relating to the *measurement* of such a provision. To illustrate consider the following fact pattern which has been simplified to focus on the principles:

A company is a defendant in a law suit and is advised by their lawyers that the company has an 80% chance of losing the case. On this basis the company exercises its judgement and determines it is appropriate to recognise a provision (i.e. it asserts in its financial statements that it has a present obligation, even though there is still some uncertainty over whether, in fact, it has such an obligation). The lawyer also advises that if the company loses the case it is certain that it will cost the company 100. However, if they win the case it is certain that the company will pay nothing.

The question is whether the possibility of *winning* the case has any relevance to the measurement of the asserted present obligation being that the company will *lose* the case:

(a) if only those outcomes which are consistent with the assertion that the entity has a present obligation are taken into account, then the company would record a provision of 100 i.e. the certain cost that arises if they lose;

(b) if all possible outcomes of the lawsuit for the company are taken into account, including those inconsistent with the assertion that there is a present obligation, then a provision would be recorded for 80 being the probability-weighted outcome of the lawsuit.

Currently, it is common practice to measure the provision in such circumstances at 100 i.e. the amount that would be payable if the company loses the case, as this is by far the most likely outcome and therefore consistent with paragraph 40 of IAS 37. We also consider that this is the appropriate measurement in such circumstances and would not support a change in the measurement to take into account outcomes inconsistent with the assertion that a present obligation exists.

In addition, we would like the IASB to provide more guidance on the costs to be included in the measurement of a liability, particularly, the legal costs associated with a litigation. IAS 37 does not specify whether or not fees for future legal services should be included in the measurement of a provision. There is diversity in the treatment of legal costs when an entity is defending a litigation whether or not a provision for the potential settlement of litigation is recognised. We consider that costs against litigation should be recognised as incurred, and the final standard could be amended to make this clear.

We note that BC10 states that in the Board's view, the proposals in paragraph 36B clarify existing guidance in IAS 37. We are concerned that this assertion, if it appears in the new standard, will have the effect of requiring entities to apply the measurement rules in Appendix B of the ED when they are still using the existing version of IAS 37.

<u>Including a risk adjustment</u>

We have concerns with the requirement to include a risk adjustment in the measurement of liabilities. It is noted that paragraph B15 requires an entity to consider whether there is a risk that the actual outflows of resources might ultimately differ from those expected. We are uncertain as to whether calculation of this risk margin includes credit risk or simply reflects the risk that expectations may be incorrect. Therefore, we agree with the alternative views AV5 and AV6 that it is not clear what the risk adjustment is intended to represent. We consider that the existing guidance in IAS 37 about risks and uncertainties is appropriate.

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?

We disagree with the proposal that entities should include a profit margin when they measure the value to fulfil a service obligation that management intends to undertake the fulfillment internally. An entity would not usually pay a profit to a third party if the use of its available internal resources has a lower cost. In addition, we doubt whether it is appropriate to record a hypothetical profit if an entity would subsequently undertake the service itself. We share the concerns expressed in the alternative views by the dissenting IASB members that the inclusion of a hypothetical margin in the measurement of a liability would create inappropriate performance information as it reduces the profit at inception and release a profit when the liability is settled. We also question whether the act of fulfilling an obligation using internal resources gives rise to a gain that meets the definition of income in paragraph 7(a) of the Framework, which defines income as an inflow of economic benefits.

We agree with the alternative views in paragraphs AV2(b) and AV4 and comments in BC20 that investors are interested in understanding the future cash flows of the entity, and hence that an obligation to provide a good or service within the scope of IAS 37 should be measured at the expected cost of fulfilling that obligation. If the entity expects to fulfil the obligation by undertaking the service itself, the amount should be the cost it will incur to fulfil the obligation. This cost should include both direct cash flows arising from fulfillment and the indirect cost of using the entity's existing resources in the fulfillment process.

Although we do not agree with the proposal of including a profit margin in the measurement of a liability, if the IASB confirms its decision in the ED, we would like the IASB to clarify the apparent contradiction between paragraph 36B and paragraph B8. Paragraph 36B requires the use of the lowest available amount, while paragraph B8 obliges the entity to use an external market price (if available) to measure the value to fulfil a service obligation first. Only when there is no market can the entity calculate the value to fulfil based on its own costs with an added margin. If the intention of the IASB is to always require the use of the lowest possible amount, it follows that the entity should measure the value to fulfil at the lower of the amounts of external market price and expected costs plus a margin.

In addition, the ED lacks guidance as to how a profit margin should be determined where there is no market for the services. The estimation of the profit in such circumstances would be subjective and could give rise to diversity in practice.

<u>Question 3 – Exception for onerous sales and insurance contracts</u>

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?

We do not support the proposed exception in paragraph B9. We believe that onerous contracts are non-financial liabilities and that all of the guidance for non-financial liabilities, irrespective of their nature, should be included in one standard and subject to similar recognition and measurement requirements. We therefore disagree with the proposed scope exclusion.

We agree with the Board that these obligations should be measured at the expected cost to fulfil the entity's contractual obligations, but we believe – as explained above – that this principle should be applied to all non-financial liabilities.

<u>Other comments:</u>

We believe that the measurement guidance in IAS 37 on the following areas could be clarified either by way of a limited amendment to the existing IAS 37 or in the replacement standard to ensure greater consistency:

- *Cost to be included* - IAS 37 does not specify the costs that entities should include in the measurement of a liability. We note that there is also some diversity in the way the costs of fulfilling a present obligation are measured. Some companies include only direct and incremental costs that would otherwise be avoided, while others include an allocation of indirect costs.

- *Onerous contracts* – An onerous contract is one in which the unfavorable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under the contract. However, the terms of "unavoidable costs" and "economic benefits" are not defined and there is no guidance for the unit of account used to identify and recognise onerous contracts. There is consequently diversity in practice.

- *Own credit risk* – we note that it is currently unclear in IAS 37 whether own credit risk can or should be taken into account when measuring a provision. We consider that it would be consistent with the fulfil concept to ignore own credit risk when measuring the present value of the economic resources that will be required to fulfil the obligation.

We also have the following additional comments in respect of the proposals, if they are to proceed in their current form:

- *Uncertainty over whether there is a present obligation* - As mentioned above, we support the use of judgment in determining whether or not to recognise a provision in cases where it is uncertain whether or not an entity has a present obligation. However, in this regard we consider that the working draft contains insufficient guidance on how to exercise that judgement, and that this may lead to diversity in practice in identifying the point at which a "present" obligation arises when a legal case is still in progress. If the IASB's intention is that entities should not wait until a court judgement before recognising a provision (i.e. that they should make a provision even if it is not 100% certain that they have a "present" obligation), then we believe that the guidance in paragraph 16 of IAS 37 should be retained as providing clarity on how this judgment is expected to be exercised.

- *Contingent assets* – It was noted that the new working draft issued in February 2010 only considers liabilities but does not mention the treatment of contingent assets after replacement of IAS 37. Common examples of contingent assets under current IAS 37 are legal cases where the reporting entity is the plaintiff, claims for the refund of taxes that are not income taxes, and insurance claims. Such assets are not currently recognised until they are virtually certain and we believe this treatment to be appropriate. While we understand that these items are assets, or potential assets, and not non-financial liabilities, we are concerned that removing the existing guidance without replacement will increase diversity in practice. For example, we believe that some entities may recognise these (and similar) assets earlier, when their recoverability is less certain, in the absence of specific guidance.