IAASB
INTERNATIONAL AUDITING AND ASSURANCE STANDARDS BOARD

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May 21, 2010

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear David,

Re: Comments on IASB's Exposure Draft on Measurement of Liabilities in IAS 37

As indicated in my letter to you on 15 April 2010, we have established a working group to monitor the development of the IASB project on Liabilities. The focus of the Working Group is to identify significant aspects of IASB proposals which could pose difficulty in an auditing context and therefore where the IAASB members' expertise can add value to the IASB's deliberations – for example, aspects of proposals where preparers' compliance may not be able to be achieved on the basis of objective evidence or where the basis for their judgments may be difficult to substantiate.

The Working Group has considered the following:

- Exposure Draft ED/2010/1: Measurement of Liabilities in International Accounting Standard (IAS) 37 (Exposure Draft)
- Working Draft of International Financial Reporting Standard [X]: Liabilities (Proposed IFRS)

We believe there are a number of proposed requirements in the proposed IFRS that could be problematic from a verifiability/auditability perspective. The Appendix to this letter includes, in the Working Group's view, comments on what are likely to be the most substantive issues from an auditing perspective resulting from the IASB's proposals.

Where possible, the Working Group has offered suggestions for the IASB's consideration as to how language in the proposed IFRS could be amended to address the issues noted. The Working Group also encourages the IASB to explicitly incorporate into the proposed IFRS itself sufficient guidance and explanation of the intent of the requirements to ensure consistency in interpretation in practice, by both preparers and auditors. For example, as explained more fully in the attachment, we encourage the IASB to include in the proposed IFRS some of the discussion from the 7 April 2010 IASB Staff Paper[1] regarding the recognition of liabilities arising from lawsuits.

[1] IASB Staff Paper (7 April 2010), "Recognizing Liabilities Arising from Lawsuits"

The IAASB looks forward to continuing to work with the IASB as early as possible in its standard-setting processes. I hope you find the comments in the Appendix valuable and encourage you to engage us in further dialogue if necessary as you finalize the proposed IFRS.

Yours sincerely,

Prof. Arnold Schilder

Chairman, IAASB

Appendix

IASB EXPOSURE DRAFT (JANUARY 2010)—

MEASUREMENT OF LIABILITIES

Comments of the IAASB Working Group

OVERALL COMMENT

For every significant accounting estimate, including the recognition and measurement of a liability, where there exists uncertainty as to the eventual outcome, there are numerous judgments that management must make. Some of these judgments are likely to be difficult and management's assertions relating to the recognition and measurement of liabilities for purposes of their financial reporting will need to be supported by sufficient and appropriate underlying evidence. The proposed measurement model, while intellectually coherent, introduces additional complexity and variables in comparison to the current version of IAS 37,[2] which is widely understood by the global community of financial statements preparers, auditors and users.

The Working Group encourages the IASB to consider whether the additional costs and effort that will need to be incurred in order to comply with the proposed requirements will indeed result in accounting estimates that are significantly more useful to users of financial statements than would otherwise be obtained from a more streamlined process. Our Working Group was not convinced that the proposed IFRS will result in improved financial reporting.

While the Working Group understands that the IASB, through its Exposure Draft, is seeking comments only on the recognition aspects of the proposed IFRS (which had previously been exposed for comment), the Working Group feels that the recognition criteria and the measurement criteria are inextricably linked and therefore offers in this letter comments relating to both criteria for the IASB's consideration.

INTERACTION OF RECOGNITION CRITERIA WITH MEASUREMENT CRITERIA

Issue Description

The proposed IFRS defines a liability as a present obligation of an entity arising from past events, the settlement of which is expected to result in an outflow of resources embodying economic benefits. It continues to explain that an obligation arises when an entity: (a) has a duty or responsibility to perform in a particular way; and (b) owes that duty or responsibility to another party or parties, who will either benefit from the entity's performance or suffer from its non-performance.[3] The proposed IFRS requires the entity to take the probability of expected future outflows into account when measuring the obligation, but not when determining whether an obligation exists. The Working Group believes that this approach may prove quite difficult to understand and apply.

For example, in the case of legal disputes, it may often be uncertain as to whether the entity has an obligation, indeed, that may be the reason for the legal dispute. However, paragraph 22 of the proposed IFRS states the following (emphasis-added):

[2] IAS 37, "Provisions, Contingent Liabilities and Contingent Assets"

[3] Paragraphs 8 and 9 in the proposed IFRS.

22 The Framework defines a liability as a present obligation 'the settlement of which is expected to result in an out flow from the entity…'. [This] *does not require a particular degree of certainty* that an outflow of resources will occur. Present obligations [may] meet the definition of a liability even if the likelihood of an outflow is low.

The Working Group believes that many preparers and auditors are likely to intuitively take into account the probability of the entity ultimately having to make a payment as a result of the lawsuit in evaluating whether an obligation exists. As noted in paragraph 9 of the 7 April 2010 IASB Staff Paper, if an entity judges that a claim is valid, it is likely to be very infrequent that the available evidence will support a prediction that it is not probable that any payment (even a small payment) will be required to settle the claim. The corollary is surely that taking the probability of payment into account ought to be a good indication of the existence of an obligation.

Whilst the proposed approach may be conceptually sound, the Working Group believes that, in practice, it is going to be difficult to completely separate consideration of the "uncertainty of the existence of an obligation" from the "probability of the outflow of resources". The probability of outflow of resources is likely to influence preparers' and auditors' judgments, implicitly if not explicitly, regarding whether or not a liability exists. For these reasons, removing the probability of an outflow of resources as a criterion in recognition may be something to be considered when the IASB weighs the cost/benefit of the proposed revision.

Further, paragraphs 14-16 of the proposed IFRS provide guidance as to how management should judge *whether an obligation exists*, stating that management is required to take into account *all* available evidence, whilst giving more weight to the evidence that is more persuasive. The proposed IFRS provides a list of possible sources, but notes that it is not exhaustive.

The Working Group is of the view that the reference to *all* available evidence may set an onerous benchmark that will not be practicable for management to implement, nor for the auditor to audit. Further, the Working Group recommends that it should be made clear in the proposed IFRS that in determining the existence of an obligation, management should consider, based on evidence that is reasonably practicable to obtain, whether *or not* the obligation in fact exists. The Working Group believes that this is important for the avoidance of bias and over-provisioning.

Actions that IASB May Wish to Consider

For reasons articulated above, the Working Group questions whether the proposed approach to recognition and measurement of liabilities will achieve the IASB's aim of clarifying the extant IAS 37, and whether it will prove easier for preparers and auditors to apply in practice. In particular, removing the probability of an outflow of resources as a recognition criterion may be something to be considered when the IASB weighs the cost/benefit of the proposed revision.

In the event the IASB decides to proceed with the revision, the Working Group recommends revisions (marked) to paragraph 14 of the proposed IFRS as follows:

14 In such situations, the management of the entity shall judge whether <u>or not</u> an obligation exists, taking into account all <u>reasonably</u> available evidence and giving more weight to the evidence that is more persuasive. The nature and extent of the available evidence will depend on the circumstances. It would include:

(a) … (f)

This list is not exhaustive. If other sources of evidence exist and are reasonably practicable to obtain, management shall also consider the evidence from those other sources.

Further, the Working Group recommends clarifying paragraph 22 of the proposed IFRS as follows:

22 The Framework defines a liability as a present obligation 'the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits'. This part of the definition may be influenced by, but does not require a particular degree of certainty that an outflow of resources will occur. Present obligations that are capable of resulting in an outflow of resources meet the definition of a liability even if the likelihood of an outflow is low. Judgment will be required in determining whether a low likelihood of an outflow indicates: (a) that an obligation does not exist or (b) the existence of a present obligation which has a low likelihood of an outflow of resources.

LEGAL AND INDIRECT TAX DISPUTES

Issue Description

The proposed IFRS provides application guidance on identifying and recognizing liabilities is relation to restructuring activities, onerous contracts and asset decommissioning and environmental rehabilitation obligations. The Working Group believes that such guidance is very useful in ensuring consistent interpretation of the requirements. If the requirements of the financial reporting are not sufficiently clear, there is an increased likelihood that preparers and auditors of financial statements may differ in their interpretations of the requirements and so generate inconsistencies and possible conflicts.

The proposed recognition and measurement models present particular challenges in relation to uncertainties where there is a binary outcome namely, the entity's position either prevails or it does not. Such binary outcomes are prevalent in cases of legal and indirect tax disputes.

The Working Group is of the view that additional application guidance should be provided in respect of legal and indirect tax disputes. The Working Group found the 7 April 2010 IASB Staff Paper on recognizing liabilities arising from lawsuits very useful in articulating how the principles of the proposed IFRS should be applied in the context of legal disputes. The explanation provided was different from how many Working Group members had originally thought the requirements would apply, suggesting that widely varying interpretations could emerge in practice without the benefit of the additional guidance in the proposed IFRS.

Actions that IASB May Wish to Consider

The Working Group recommends the inclusion of guidance on the determination of whether a liability exists in legal and indirect tax disputes in the body of the proposed IFRS in Appendix C, where similar guidance has been provided for other of liabilities. It would be helpful if guidance could address in particular, how the existence of a present obligation, and consequently the recognition of a liability, relates to the likelihood of the entity's position prevailing, including the views of internal and external legal counsels and, if present, legal precedents in similar cases which are likely to be the best available means of determining the current views of the courts.

The 7 April 2010 IASB Staff Paper contains very useful guidance on this point, in particular paragraphs 4 and 5. The Working Group recommends that similar guidance be included in the final IFRS. As the Staff Paper explicitly states that it is not an official pronouncement of the IASB, the intended effect may not be achieved if such guidance is not incorporated into the body of the IFRS.

QUESTION 1 – Overall Requirements

MEASUREMENT OF LIABILITIES

Issue Description

The proposed IFRS requires that a liability be measured at the amount that an entity would rationally pay at end of the reporting period to be relieved of the present obligation. This amount is defined to be the lowest of the following:

(a) The present value of the resources required to fulfill the obligation;

(b) The amount that the entity would have to pay to cancel the obligation; and

(c) The amount that the entity would have to pay to transfer the obligation to a third party.[4]

The proposed IFRS does not set out what is intended by the use of the word “rationally”, although proposed paragraph 36B implies that it is the lowest amount the entity would pay using three different measurement methods.

In determining what is “rationally” the lowest amount that the entity may pay at the end of the reporting period, preparers are expected to give consideration to a number of different factors, some of which involve varying degrees of judgment, such as appetite for risk. This creates challenges from an auditing perspective as the auditor will be required to evaluate whether the decisions taken by management in making those measurements, and the reasons for supporting these decisions, should be considered “rational”.

Further, the proposed IFRS requires the entity to measure a liability at the *lowest* amount that may be obtained through application of the three methods of measurement described in the proposed IFRS. To determine which amount is the lowest, the entity would need to compute (or at least estimate) all three possible values in order to be able to conclude that measuring a liability using a particular method will provide it with the lowest value. However, there may be cases where management may assert that one of those methods will produce the lowest without actually demonstrating that the other values are higher. From an auditing perspective, the auditor will be challenged in such cases to obtain sufficient evidence to evaluate management’s assertion.

In addition, the terms “cancel” and “transfer” are not defined in the proposed IFRS and therefore may be open to varying interpretations. For example, the terms could be understood to mean that an obligation is legally cancelled or transferred, or that the related risks are transferred to a third party even though the legal obligation itself is retained. Clarification on this point through the inclusion of definitions would be useful.

Also, paragraph 23 of the proposed IFRS states that “[e]xcept in extremely rare cases, an entity is able to identify a range of possible outcomes and determine a measure of a liability ... to meet the recognition criteria.” The Working Group is of the view that this assertion may be overstated as the circumstances where management is not able to reliably measure liabilities may be relatively common. This is particularly in the case of a non-financial liability for which there is no market.

[4] Paragraphs 36A and 36B in the proposed IFRS.

Actions that IASB May Wish to Consider

The Working Group is of the view that management should not be required to address, for each obligation, all three measurement methods contained in paragraph 36B to be able to determine which results in the lowest figure. This approach is not likely to be efficient and, as is noted in paragraph 36C, some of the options may not be possible. Further, the auditor would need to obtain sufficient assurance that management has carried out all the required steps and arrived at the right conclusion.

The Working Group recommends that the IASB consider adopting an approach that does not require the entity to perform such extensive computations for all its obligations. This may be achieved through amalgamation of paragraphs 36A and 36B and effecting revisions as follows:

36A 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.~~

~~36B The amount that an entity would rationally pay to be relieved of an obligation is the lowest of~~:

(a) the present value of the resources required to fulfill the obligation, measured in accordance with Appendix B;

(b) the amount that the entity would have to pay to cancel the obligation; ~~and~~ <u>or</u>

(c) the amount that the entity would have to pay to transfer the obligation to a third party.

<u>Where an amount can reasonably be determined in accordance with more than one of alternatives (a), (b) or (c), the liability shall be measured at the lowest amount.</u>

The Working Group also suggests that the Basis for Conclusions outlines how this requirement will result in a liability which an entity would rationally pay to settle an obligation, ensuring the principle remains without having the definitional problems that arise when it is embedded directly in the requirement.

Separately, the Working Group believes that it would be helpful to clarify the IASB's intention as to whether the terms "transfer" and "cancel" are to be given the same meaning as is understood in relation to IAS 39[5] on derecognition of financial assets and liabilities.

ESTIMATION OF EXPECTED PRESENT VALUE

Issue Description

The proposed IFRS requires the entity to take into account the range of outcomes associated with the fulfillment of an obligation and their effect by estimating the expected present value of outflows in each case. The proposed IFRS further indicates that it is not always necessary to consider distributions of literally *all* possible outcomes but rather, a limited number of discrete outcomes and possibilities can often provide a reasonable estimate of the distribution of possible outcomes. [6]

The Working Group agrees with the IASB's position. However, the proposed IFRS may be read as implying management may make an estimate based on broad approximations which the Working Group views as reasonable, but which could be materially different from an estimate made with greater precision. To prevent such outcomes, management should be required to ensure that the limited number

5 IAS 39, "Financial Instruments – Recognition and Measurement"
6 Paragraphs B3 and B4 in the proposed IFRS.

of outcomes considered is appropriate and fairly represents the range of all outcomes anticipated by management to be possible.

In relation to this, the ISAs permit, amongst other audit procedures, the auditor to undertake an independent computation of the expected value outflows in evaluating the entity's conclusion in this regard.[7] Auditors are directed to give consideration to the related guidance in the accounting framework when performing procedures. Therefore from an auditing perspective, any clarification in the proposed IFRS in this area is welcomed.

Actions that IASB May Wish to Consider

The Working Group recommends revision to paragraph B4 of the proposed IFRS as follows:

> In some cases, an entity might have access to extensive data and be able to identify many outcomes. In other cases, the information available to the entity might be more limited. 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. <u>The limited number of discrete outcomes used should be representative of the range of outcomes considered by management to be possible.</u>

QUESTION 2 – Obligations Fulfilled by Undertaking a Service

OWN PROFIT MARGIN

Issue Description

Paragraph B8 of the proposed IFRS sets out the requirement for measuring an obligation which will be fulfilled by undertaking a service as: (a) the amount estimated to have to be paid in order for a contractor to perform the service; or (b) the estimated amount that would be charged to a third party (to perform the work necessary to fulfill the obligation (costs expected to be incurred together with a profit margin).

The Working Group is of the view that the requirement for a profit margin to be incorporated in the amount estimated presents challenges to both preparers and auditors of financial statements as it raises questions such as what would be a reasonable profit margin to include and, for the auditors, how to determine the reasonableness of the profit margin determined by management? If an entity is intending to fulfill an obligation, the profit margin will eventually be recognized as a gain in the income statement in future periods. In these cases, the auditor will be alert to the risk of manipulation of results by the entity through varying the profit margin applied.

Actions that IASB May Wish to Consider

The Working Group recommends the removal of the requirement for a profit margin to be included in the measurement of the liability when the entity intends to undertake the work itself to fulfill the obligation, or otherwise provide guidance on how an entity should determine what profit margin should be included when there is no market for the particular service.

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[7] Paragraphs 13(d) and A90 in ISA 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures".

RISK ADJUSTMENT

Issue Description

Paragraph B15 of the proposed IFRS requires a risk adjustment to be applied to the expected present value if the entity would pay such an amount to be relieved of this risk. The example on page 37 of the proposed IFRS illustrates an amount of 5% which is supported by minimal guidance as to how this amount is derived or how management might determine such an amount. It is not clear whether or how these risks might have already been included in the probabilities used for determining the expected value, whether applying such a risk adjustment is ascribing a degree of precision to what is an accounting estimate, or whether the risks are being double-counted. From an auditing perspective, auditing this estimate without a clear rationale will require significant judgment by the auditor.

Actions that IASB May Wish to Consider

The Working Group recommends the removal of the requirement for an additional risk adjustment to be applied or alternatively that guidance on how such a risk adjustment might be calculated be provided.