fei
financial executives international
canada

May 19, 2010

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

Re: Exposure Draft – Measurement of Liabilities in IAS 37 – Proposed amendments to IAS37

The Committee on Corporate Reporting of Financial Executives International Canada (FEI Canada) is writing this letter to provide its response to International Accounting Standards Board's (IASB) **Exposure Draft – Measurement of Liabilities in IAS 37 – Proposed amendments to IAS37** (ED).

FEI Canada is the all-industry professional membership association for senior financial executives. With eleven chapters across Canada and more than 2,000 members, FEI Canada provides professional development, thought leadership and advocacy services to its members. The association membership, which consists of Chief Financial Officers, Audit Committee Directors and senior executives in the Finance, Controller, Treasury and Taxation functions, represents a significant number of Canada's leading and most influential corporations.

The Committee on Corporate Reporting (CCR) is one of two national advocacy committees of FEI Canada. CCR comprises more than 30 senior financial executives representing a broad cross section of the FEI Canada membership and of the Canadian economy who have volunteered their time, experience and knowledge to consider and recommend action on a range of issues related to accounting, corporate reporting and disclosure. In addition to advocacy, CCR is devoted to improving the awareness and educational implications of the issues it addresses, and is focused on continually improving the standards and regulations impacting corporate reporting.

Our responses to the questions raised in the ED are set forth as laid out in the ED:

<u>Question No 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?

While we agree with the overall premise in paragraph 36A that "an entity shall measure a liability at the amount it would rationally pay…to be relieved of the obligation" we disagree with the "measurement method" proposed in paragraph 36B ("36B").

36B requires the liability to be measured at the lowest of (a) the present value of the resources required to fulfill the obligation in accordance with Appendix B, (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. IAS 37, as it currently stands, requires a liability to be measured based upon a "most likely outcome" approach and 36B (a) replaces this "concept" with measurement being based upon the present value of the resources required to fulfill the obligation taking into account the probability weighted average of the present values of the expected outflows for the possible outcomes.

We think that the measurement of such liabilities using the "probability of outflows" approach versus "most likely outcome" approach is inappropriate as the weighted average of all possible outcomes reflects the inherent uncertainty in the estimate but is almost never equal to the actual amount paid and is therefore not a decision useful number. The IASB Staff Paper Recognising liabilities arising from lawsuits issued on April 7, 2010 provides additional understanding of the proposed recognition criteria and its application to lawsuits. We believe incorporating elements of the concepts presented in this Staff Paper in the final standard would ensure consistent application of the intent of the standard to trivial claims. For instance if there is low probability that certain litigation would be settled, currently, IAS 37 would not require any amount to be provided for. However in such situations, 36B could be interpreted to require that an amount be recorded although the actual amount expected to be paid is – quite simply – nil. Similarly, trivial claims that have a remote likelihood of settlement may need to be recorded and this could lead to situations where the financial statements are misleading since liabilities could be materially overstated. Such situations are, we believe, better dealt with through "robust" disclosure versus "forcing" income statement recognition.

The probability weighted average approach is reasonable when applied to revenue related items such as product warranties but could cause a misstatement of liabilities when applied to single liabilities where one of the outcomes is a low-probability high-outflow scenario. For instance, if an entity believes that there is 65% probability that certain litigation will be settled for $1,000,000, 30% probability that it will settled for $500,000 and 5% probability that it will settled for $1,000,000. The ED would require this litigation to be recorded at $805,000 whereas we believe the more "appropriate" amount that should be recognized is $1,000,000 since that is the probable amount at which the liability will be settled. This could lead to significant over- or understatement of presented liabilities.

Furthermore, we believe that a requirement to apply a risk adjustment in the measurement of a liability will require practical guidance and this guidance should be made available with or before this standard is finalized as it would otherwise lead to

significant differences in how each entity interprets the measurement of the risk adjustment.

The measurement “methods” suggested in 36B (b) and (c) are essentially akin to the concept of the “settlement” of the liability which would be appropriate for fair value accounting when a business combination is being contemplated. However, the cancellation of “normal course” obligations or transfer of obligations to a third party are, generally speaking, rare events for an entity that is accounting for its activities on a going concern basis and, as such, these concepts have relevance only when the entity is actively seeking to either cancel the obligation or to transfer it to a third party. Conceptually, it would seem appropriate that an entity would pay the “lowest of” the three amounts listed in paragraph 36A to settle a liability. But the “lowest of” concept ignores other alternatives to settlement which might be necessary to preserve, for instance, the entity’s reputation or its relationship with its clients. Consistent with our comments above, we think the liability should be measured at the most likely amount to be paid.

Overall, we therefore believe that the existing approach under IAS 37 result in the recognition of an amount (and in some cases the recognition of no amount) that would be more clearly and closely linked to the ultimate amount expected to be paid. Recognition of an amount based upon the “probability of outflows” method would lead to the recording of; arguably, inaccurate amounts and this would not be decision useful to the readers of the financial statements.

<u>Question No 2- Obligations fulfilled by undertaking a service</u>

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?

We do not agree with the premise that a margin should be included in the determination of costs to fulfill the obligation when the obligation is expected to be settled using internal resources. The inclusion of the margin will result in the overstatement of the “true” cost of the liability and will also result in the recognition of “hypothetical” profit at the time of the settlement of the liability since the liability will not reflect the entity’s expected cost to settle the liability. Also, the margin (in such cases) is not a true outflow of cash that is necessary for the purpose of settling the obligation and it would therefore not be appropriate to include the margin in the recognition of the liability.

Additionally, we disagree with the premise in paragraph BC 21(a) – that "similar liabilities are measured at similar amounts irrespective of the preparer's assumptions about the extent to which the entity will employ internal resources rather than contractors to fulfill the obligation. Because many of the obligations will not be fulfilled for some time, intentions could change." Paragraph BC 21(a) suggests that the valuation of liabilities is similar between different entities and that the intended manner of settlement is not relevant. We believe that "intention" is a significant factor that needs to be taken into account when valuing liabilities that are settled through internal resources especially when the entity has a history of using internal resources and the ability to continue to do so in the future. Failure to so incorporate "intent" could result in a material overstatement of liabilities. We believe that measurement of an obligation should reflect the entity's ability to effectively manage the settlement of its obligations rather than reporting the liability at generic market rates.

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?

We are supportive of and agree with this exception.

We appreciate your consideration of the comments made in this letter and welcome the opportunity to further discuss any and all matters related to this ED.

Yours very truly,

Victor Wells
Chair
Committee on Corporate Reporting
FEI Canada