EFRAG

European Financial Reporting Advisory Group

28 November 2005

International Accounting Standards Board
Henry Rees
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Email: CommentLetters@iasb.org

Dear Henry,

Re: ED of Proposed Amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and IAS *19 Employee Benefits*

On behalf of the European Financial Reporting Advisory Group (EFRAG) I am writing to comment on the Exposure Draft of Proposed Amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and IAS *19 Employee Benefits* ("EDs").

This letter is submitted in EFRAG's capacity of contributing to IASB's due process and does not necessarily indicate the conclusions that would be reached in its capacity of advising the European Commission on endorsement of the definitive IFRSs on the issues.

In line with our introductory comments in our response to proposed amendments to IFRS 3 and IAS 27 we support the objective of this project to achieve convergence on a global level for the accounting for business combinations. However, some of the proposals related to IAS 37 clearly go beyond that what is necessary to achieve that objective. In our view, it is premature to make major conceptual changes to the accounting treatment of non-financial liabilities at a time when the framework itself is under active review and, bearing in mind significant implementation difficulties that we think are likely to arise from such changes, before the proposals have been adequately researched or field tested.
We regard the proposals as major changes to existing and established concepts. Whilst we can accept minor changes resulting in deviations from the current Framework we do not support any major conflicts with the Framework. Introducing major changes in the way the EDs are proposing damages the authority of the Framework and creates the risk that changes that may be appropriate in particular circumstances will at some future date be extended to other circumstances without proper debate.

We explain our main concerns in more detail in the following section of this letter before responding, in the Appendix, to the particular questions raised in the EDs. However, summarising our concerns, we believe the proposed changes

1. are not in compliance with the current framework with regard to the recognition of assets and liabilities and should not be introduced until there has been an opportunity to have a full debate on them as part of the framework review,
2. introduce a default category for non-financial liabilities without sufficient analysis or understanding of the range of liabilities that might as a result be brought within the scope of the standard, and

3. introduce a high degree of subjectivity particularly for the measurement of low probability, but potentially significant, “one-off” liabilities thereby reducing the reliability of information overall.

As a result we do not support the main changes included in the proposals. We recommend that the Board should not introduce the main parts of the proposals into IFRS, but should instead maintain the current recognition and measurement principles for contingencies. We are aware that this approach leads to a different measurement approach for liabilities on a portfolio and on a stand-alone basis, but believe that the outcome more faithfully represents economic reality. In other words we believe that contingencies should be recognised only when the future in- or outflow of economic benefits is probable; disclosure of all remaining contingencies supplemented by additional information is considerably more useful for potential investors than recognition of assets and liabilities at a rather vague amount that will often be regarded as irrelevant.

Main Concerns with the Proposed Amendments to IAS 37 and IAS 19

The ED of Proposed Amendments to IAS 37 makes several proposals that are likely to have far-reaching implications. Perhaps the most significant of those relate to the probability recognition criterion and the measurement of single liabilities.

1. Probability recognition criterion

The ED proposes that probability, which is currently taken into account in the recognition criteria, should henceforth be dealt with via measurement instead. Although this change is being introduced as part of the Business Combinations project, it will have an impact beyond acquisitions. We have studied the proposed approach based on unconditional and conditional rights and obligations, and we fear that in practice it will be extremely difficult to implement. We note that, as far as we are aware, the Board has not made field visits or tests to explore the practical consequences of the proposal – particularly in the area of non-contractual liabilities and legal cases where the outcome may be highly uncertain - before issuing the ED.

In our view the proposal is not sufficiently clear about what the triggering event for the unconditional obligation (or right) is resulting in the recognition of a liability (asset). Looking at the examples provided, it does not become much clearer: is it the moment a seller becomes aware of a mistake, is it the start of legal proceeding or is there a stand-ready obligation as soon as somebody decides to start a business and enters into non-contractual obligations?

As a result, we do not support the change.

2. Measurement

The ED also proposes that *all* liabilities – on a single and portfolio basis - that are not financial liabilities should be measured at the amount that an entity would rationally pay to settle the present obligation or to transfer it to a third party on the balance sheet date. Such a proposal has important implications for the measurement of performance obligations for example, and thus impacts on Phase II of the insurance project, revenue recognition and a range of other long-term, highly complex, difficult projects. In these areas of accounting, exceptions are currently made to the principles mentioned in the first sentence of this paragraph. However, rather than explore those exceptions to understand why they have been considered necessary, the Board is simply proposing to reinforce the basic principle. We believe it is premature to bring forward such proposals until the Board has carried out an in-depth analysis of all the implications of the proposal.

One implication of the measurement proposal is that an expected cash flow approach can be used as the basis for measuring both a class of similar non-financial obligations (as at present) and a single non-financial obligation. For example, if the reporting entity is being sued for €10m and there is thought to be only a 10% chance of success, the entity would recognise a liability of approximately €1m even if it is thought that the only possibilities are that nothing will be paid out or €10m will be paid out. Depending on the eventual outcome, either a profit of €1m or a loss of €9m will subsequently be recognised. We think there needs to be a thorough analysis of how useful such numbers are.

Another implication seems to be that, when an entity receives payment for performance in advance of that performance taking place, the entity would recognise a liability for the amount it would rationally pay to legally lay-off the performance obligation. This was for some time also the proposal in the revenue recognition joint project that the IASB and FASB are carrying out. However, recently both Boards have concluded that there are serious practical difficulties in applying such an approach[1]. It seems odd that an approach that has so recently been put aside in this way should be used as the underlying principle in this radical revision of IAS 37.

3. Convergence Aspect

It is also worth noting that the proposal does not result in fully converged standards because of (i) the proposed treatment of contingencies and (ii) the draft revised IAS 37 requires a regular adjustment of discount rates whereas the equivalent US standards such as SFAS 143 does not. Bearing in mind the emphasis that both Boards are now putting on convergence, this is very disappointing. We have taken this failure to achieve convergence into account in reaching conclusions about the proposals.

Incidentally, we believe that the FASB is dealing with the subject in the right order by launching a consultation on the basis of the IASB proposals as part of the conceptual framework project; they are not considering any change to SFAS 5 at this stage.

Summary of EFRAG recommendations

Based on our analysis we do not support all the proposals in the EDs. We therefore recommend that the Board should:

1. Adopt all the proposed changes to IAS 37 except for:
    a. The removal of the probability criterion
    b. The change in the measurement principle
2. Adopt all the proposed changes to IAS 19 subject to:
    a. Defining the term “short-term” to make it practicable, and
    b. Changing the treatment of voluntary benefits. In our view such benefits can give rise to a constructive obligation in the same way accepted for other liabilities
3. Carry out further research and field testing for the new concepts mentioned in 1. above.

If you have any question concerning our comments please contact either Reinhard Biebel or me.

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman

[1] See IASB update June 2005, page 3: „The Board reiterated its view that the legal lay-off amount was the most relevant measure of a performance obligation. However, it acknowledged concerns about the practical problems and measurement uncertainties that might arise in applying this approach.

ED OF PROPOSED AMENDMENTS TO
IAS 37 *Provisions, Contingent Liabilities and Contingent Assets and*

Question 1 – Scope of IAS 37 and terminology

(a) Do you agree that IAS 37 should be applied in accounting for all non-financial liabilities that are not within the scope of other Standards? If not, for which type of liabilities do you regard its requirements as inappropriate and why?
(b) Do you agree with not using 'provision' as a defined term? If not, why not?

EFRAG Response:

(a) We have previously pointed out in other contexts that some types of liability appeared not to fall within the scope of any IFRS. For that reason, in principle and conceptually we support the introduction of an appropriate default standard for non-financial liabilities in the long-term.
It is however important with a default standard that its implications for all the liabilities that will fall within its scope are carefully considered. It would, for example, have been useful had the Board identified the liabilities it thought would be affected by this widening in the scope of IAS 37 and explained why the revised standard was appropriate for them. We think one important example might be up-front payments: although there is some guidance in the standard it is not clear to us whether they fall under IAS 18 (or IAS 11) or this standard. Another example is the broad category of performance obligations, the accounting of which in our view should remain unchanged for the moment in advance of other conceptual work.
Our view is that a default standard should not be introduced until the Board has carried out that further analysis.

(b) We agree with the Board's decision not to use 'provision' as a defined term. We also note that it remains possible for entities to describe some classes of non-financial liabilities as provisions in their financial statements and we believe this should be made even clearer in the text of the final standard.
We want to add that "non-financial liability" is not our preferred label, because it might imply that the liabilities we are dealing with are not financial.

Question 2 – Contingent liabilities

(a) Do you agree with eliminating the term 'contingent liability'? If not, why not?
(b) Do you agree that when the amount that will be required to settle a liability (unconditional obligation) is contingent on the occurrence or non-occurrence of one or more uncertain future events, the liability should be recognised independently of the probability that the uncertain future event(s) will occur (or fail to occur)? If not, why not?

<u>EFRAG Response:</u>

(a) Credits that are recognised in the balance sheet (except for equity) are liabilities. Therefore, either a contingent liability is a particular type of liability, or it is something that would have been a liability had something been slightly different. We realise that the term is currently used in both ways, which is confusing. However, we disagree with the elimination of the concept of contingencies.

(b) We can see some merit in the concept of unconditional and conditional rights and obligations at least from a theoretical point of view. As mentioned, we are, however, concerned about the serious practical implications. The main weakness of the proposal in our view is the remaining uncertainty about what is the *obligating event*. We refer to the Illustrative Examples section of the proposed ED and in particular to *Example 1 Disputed lawsuit* and *Example 2: Potential lawsuit*:

a. considering example 1 the text states that the past event is the start of legal proceedings since until then the entity was not aware that it had sold harmful food. However, in reality, even after the start of legal proceedings the entity may not actually know whether it has sold harmful food. Suppose the obligating event would be selling the food rather than the legal proceedings, a company would have to provide for all its stand-ready obligations, which does not seem to be our preferred approach.

b. considering example 1 the text says that the past event for the unconditional obligation is the start of legal proceedings, because up to this point the entity was not aware that it can be found guilty. In contrast, example 2 suggests that there is a stand ready obligation when the entity knows that it has done something wrong that will result in litigation. If the operation is the obligating event, the hospital would have to provide for all kinds of potential litigation, which we believe is not the right accounting. We could think of a slightly different - but still realistic - example 2, where the hospital did not think it had made a mistake but suspected nevertheless that the patient's family would litigate. We fear the provided guidance is not sufficient to determine the obligating event then.

We agree with the dissenting Board member that in the absence of a clear definition of the conditions for recognising when an unconditional (stand ready) obligation exists, the practical implications of the new approach are very unclear (AV5). We disagree with the underlying assumption that in the case of a stand-ready obligation the mere standing ready for something creates an outflow of benefits as argued by the Board in paragraph 24 of the proposed amendments to IAS. In our view, a stand ready obligation should only result in the recognition of a liability if it is probable that there will be an outflow of benefits. We do not follow the logic behind the concept proposed by the Board, e.g. in the case of a lawsuit. Would the mere standing ready to await the judges decision – in favour of the entity or against – lead to an in- or outflow of benefits? Our understanding is yes, under the Board's proposal, but we disagree.

Measuring contingencies of high amounts with low probability for an outflow of economic benefits can result in a range of values based on a high level of subjectivity. In our view this does not serve user needs and provides less relevant and reliable information than the figures presented under the current standard. Taking into consideration that this applies also in situations outside business combinations we do not support the change. In order to ensure that the proposal is workable the Board has to develop an unambiguous and clear principle.

We remind the Board that the question of the obligating event is mentioned as one of the cross-cutting issues in the conceptual framework project.

Question 3 – Contingent assets

(a) Do you agree with eliminating the term 'contingent asset'? If not, why not?

(b) Do you agree that items previously described as contingent assets that satisfy the definition of an asset should be within the scope of IAS 38? If not, why not?

<u>EFRAG Response:</u>

(a) We disagree with eliminating the concept of 'contingent asset' for the reasons explained under our response to Question 2.

(b) The same arguments as used in relation to contingent liabilities can be used for contingent assets. Although we agree in principal with the application of IAS 38 in such cases we are concerned that, as the recognition criteria in IAS 38 differ from the EDs, two different recognition concepts for assets and liabilities will be created. Additional guidance in IAS 38 may be required.

It is our impression that the guidance for recognising and measuring liabilities is much more detailed than for assets. We think there needs to be more guidance on how to deal with (un-)conditional rights associated with the acquisition of assets.

Question 4 – Constructive obligations

(a) Do you agree with the proposed amendment to the definition of a constructive obligation? If not, why not? How would you define one and why?

(b) Is the additional guidance for determining whether an entity has incurred a constructive obligation appropriate and helpful? If not, why not? Is it sufficient? If not, what other guidance should be provided?

<u>EFRAG Response:</u>

(a) It seems clear from the Basis for Conclusions paragraphs BC57 and BC60 that the Board's intention was to create a higher threshold for the recognition of constructive obligations. However, it is not clear from the wording '…they can reasonably rely on…' that that has been achieved. Since it would be inappropriate just to rely on the Basis of Conclusions we suggest the Board provides additional explanation and clarification of the proposed concept and removes uncertainty as to whether the objective to increase the threshold has been achieved.

(b) Yes, subject to our comment under (a) we regard the additional guidance as appropriate.

Question 5 – Probability recognition criterion

Do you agree with the analysis of the probability recognition criterion and, therefore, with the reasons for omitting it from the Standard? If not, how would you apply the probability recognition criterion to examples such as product warranties, written options and other unconditional obligations that incorporate conditional obligations?

EFRAG Response:

Although the current fair value element of IAS 37 is admittedly not in full conformity with the Framework, we think that the current IAS 37 approach has more or less proven to be practicable. Therefore we wonder why the fundamental change of concept is needed. We believe that the Framework constitutes a reference point for accounting change - a link between existing and new standards. While we can accept minor changes resulting in deviations from the current Framework - supposed the related benefits are big enough – as mentioned in our response to the proposed amendments to IFRS 3 we do not support any major concepts changes, which are in conflict with the Framework. Introducing major changes in the way the EDs are proposing damages the authority of the Framework and creates the risk that changes that may be appropriate in particular circumstances will at some future date be extended to other circumstances without proper debate. If changes to existing concepts are being considered, we think they should first be discussed in the context of a debate on the Framework. In this context we draw your attention to paragraph BC112 of current IFRS 3, where the Board committed itself to deal with the revision of the probability criterion in the context of a project on the conceptual framework.
Furthermore, if the Board is to propose that a major conceptual change (as the one proposed in this ED) is to be reflected in an IFRS, we believe it essential that, at the same time or earlier, it should propose a change to the Framework itself.
We fear that in the end useful information as currently provided in the notes will in the future be replaced by unreliable and vague fair value information in the balance sheet. That is why we prefer the current approach of IAS 37.

Question 6 – Measurement

Do you agree with the proposed amendments to the measurement requirements? If not, why not? What measurement would you propose and why?

EFRAG Response:

As explained in our introductory comments we see major practical difficulties with the recognition and also with the measurement requirements. For example:

- **The current IAS 37 is based on the principle that a single obligation may be measured by the most likely outcome, which is a practical measurement approach. This already causes difficulty because it can be impossible to get reliable information about which outcome is the most likely outcome. Under the proposals,**

reliable probability and expected cash flow information will be needed and that is likely to be even more difficult to obtain.

- **We disagree with the proposed measurement approach. The Board has already decided in the context of its revenue recognition project that there are major practicality difficulties with the legal lay-off/exit-value approach to liabilities and therefore concluded to explore alternatives.**
  The proposed approach is based on the principle as stated in paragraph 29: *"An entity shall measure a non-financial liability at the amount that would rationally pay to settle the present obligation or to transfer it to a third party on the balance sheet date."*
  We believe that the current measurement approach under IAS 37 paragraph 36 should remain unchanged, meaning "the best estimate of the expenditure required to settle the present obligation at the balance sheet date. Therefore we also disagree with the expression "…would rationally pay…" in this context. Since it is not a defined term in the IFRS glossary, it may mean something like exit value, it may however also mean something else.
  In addition we are not sure what is meant by the word "or" since in our view the amount that an entity "would rationally pay to settle the present obligation" is no necessarily equal to the amount that it would pay "to transfer it to a third party". The two views could result in two different values.
  Further clarification is needed.

Because of these concerns, we have looked to the Basis for Conclusions for persuasive reasons why the approach is being proposed. The only argument we can find – it removes inconsistencies between the measurement of single and portfolio obligations – is not in our view persuasive, because these are two different circumstances and in the case of a large portfolio it is just easier to determine whether an outflow is probable. We would have expected that the Board as a first step further explores why exceptions to the basic measurement principles have been considered necessary to date (e.g. insurance liabilities or performance obligations in the context of revenue recognition) before simply proposing to reinforce the basic principle.
In our view, the proposals should be postponed until the conceptual questions have been thoroughly studied.

Question 7 – Reimbursements

Do you agree with the proposed amendment to the recognition requirements for reimbursements? If not, why not? What recognition requirements would you propose and why?

<u>EFRAG Response:</u>

Yes, we agree with the proposed amendments for reimbursements.

Question 8 – Onerous contracts

(a) Do you agree with the proposed amendment that a liability for a contract that becomes onerous as a result of the entity's own actions should be recognised only when the entity has taken that action? If not, when should it be recognised and why?

(b) Do you agree with the additional guidance for clarifying the measurement of a liability for an onerous operating lease? If not, why not? How would you measure the liability?

(c) If you do not agree, would you be prepared to accept the amendments to achieve convergence?

EFRAG Response:

(a) We agree with the principles but we are uncertain of the full implications of the amendments, particularly the phrase '…as a result of the entity's own actions…'. If it is the case that under the proposal an entity having entered into a rental contract that becomes onerous because market prices have decreased would have to recognise a liability, we disagree with the proposal; and if that is already the requirement under the current IAS 37 we think it should be changed. We recommend the Board clarify the intention of the proposal.

(b) Yes, subject to our response under (a).

(c) N/A.

Question 9 – Restructuring provisions

(a) Do you agree that a liability for each cost associated with a restructuring should be recognised when the entity has a liability for that cost, in contrast to the current approach of recognising at a specified point a single liability for all of the costs associated with the restructuring? If not, why not?

(b) Is the guidance for applying the Standard's principles to costs associated with a restructuring appropriate? If not, why not? Is it sufficient? If not, what other guidance should be added?

EFRAG Response:

(a) Yes, we agree.

(b) Yes, we believe the guidance is appropriate.

ED OF PROPOSED AMENDMENTS TO IAS 19 *Employee Benefits*

Question 1 – Definition of termination benefits

Do you agree with this amendment? If not, how would you characterise such benefits, and why?

EFRAG Response:

We agree with the amendment. We realise that the proposed amendment is purely based on a timing element, which can be a decisive factor in some cases. The difference in accounting for termination benefits and post-employment benefits is significant. Nevertheless, we want to emphasise that timing is only one factor and overall the substance of the arrangement offered should be considered rather than the form. We also believe it is necessary to illustrate what a "short period" means.

Question 2 – Recognition of termination benefits

Is recognition of a liability for voluntary and involuntary termination benefits at these points appropriate? If not, when should they be recognised and why?

EFRAG Response:

No, it is not appropriate, because it can be argued that a constructive obligation in the case of a voluntary termination benefit arises before the employee accepts the offer. The nature and timing of the constructive obligation can be different from jurisdiction to jurisdiction and depends on the individual circumstances.

Question 3 – Recognition of involuntary termination benefits that relate to future service

Do you agree with the criteria for determining whether involuntary termination benefits are provided in exchange for future services? If not, why not and what criteria would you propose? In these cases, is recognition of a liability over the future service period appropriate? If not, when should it be recognised and why?

EFRAG Response:

Yes, we agree.

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