

May 19, 2010

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

Dear Sirs,

Liabilities – Improving IAS 37

This letter is the response of the Canadian Accounting Standards Board to the International Accounting Standards Board Working Draft of a new “Liabilities” standard, including the proposals in the “Measurement of Liabilities in IAS 37” Exposure Draft, dated January 2010.

The Canadian Accounting Standards Board members and staff discussed these proposals with the Board’s Academic Advisory Council, User Advisory Council, Insurance Accounting Task Force and various Canadian industry associations, auditors, preparers and users. The views expressed in this letter take into account comments and perspectives raised by these stakeholders

The Canadian Accounting Standards Board supports the International Accounting Standards Board’s project to improve IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. Given the significant debate amongst stakeholders about the implications of the recognition requirements in the case of legal disputes and the inclusion of a profit margin when measuring

obligations an entity will fulfill by performing a service, we think the International Accounting Standards Board must address these key concerns before finalizing the new standard. We recommend that the proposals be revised by:

- adding a “more likely than not” threshold to assist an entity to determine if a present obligation exists; and
- requiring obligations that will be fulfilled by performing a service to be measured at the expected present value of the resources the entity expects to expend.

We think that adopting these recommendations would make the proposed improved recognition and measurement requirements practical to apply because they are based on accepted accounting practices. Accordingly, the redeliberations could be completed on a timely basis.

Over the last six years and after two exposure drafts and many discussions, the Board and its stakeholders have invested significant resources to develop these concepts. We are concerned that in commenting on these proposals, many constituents will overlook the significant improvements to IAS 37 that the Board has developed. The guidance to identify the existence of a constructive obligation, to distinguish a stand ready obligation from a conditional obligation, and to reflect uncertainty about the amount and timing of cash flows in the measurement are a few of those significant improvements we support. We think that these improvements to IAS 37 can and should be finalized, with the two modifications we recommend.

If this project cannot be completed expeditiously, we would recommend that the International Accounting Standards Board defer this project and focus on developing and issuing high-quality standards in its projects that are part of the Memorandum of Understanding with the US Financial Accounting Standards Board.

The Appendix to this letter includes an explanation of these comments, as well as other recommendations.

We would be pleased to elaborate on any of our comments in more detail if you require. If so, please contact Peter Martin, Director Accounting Standards at +1 416 204-3276 (e-mail peter.martin@cica.ca) or Rebecca Villmann, Principal Accounting Standards at +1 416 204-3464 (e-mail rebecca.villmann@cica.ca).

Yours truly,



Patricia O'Malley, FCA
Chair
Canadian Accounting Standards Board

Appendix

Canadian Accounting Standards Board Comments on the Working Draft of a new “Liabilities” standard including the proposals in the “Measurement of Liabilities in IAS 37” Exposure Draft, dated January 2010

Recognition requirements

1. We think that the revised recognition criteria are appropriate for, and can be applied to, obligations with uncertain outcomes, such as contractual, statutory and constructive obligations. The revised recognition approach is logical and conceptually compelling. In principle, we support the removal of thresholds and prefer the use of judgement. We think that for the types of obligations listed above, the use of judgement to determine whether a present obligation exists should not be more difficult than many of the other judgements entities must make in preparing financial statements. As thresholds are often evaluated on a numerical basis, the inability of an entity to distinguish between a 49% chance and a 51% chance that an obligation exists demonstrates the problem with using thresholds.
2. For situations that involve uncertainty about the existence of a present obligation the criteria will require an entity to make a binary decision. That is, the entity must judge if an obligation exists or not when it is faced with a probability distribution on that issue similar to the one it faces when there is uncertainty about the measurement. An uncertain situation, such as a legal dispute, can have attributes similar to both a risk and an obligation. Accordingly, such decisions involve weighing the probabilities of whether the item is a risk or an obligation. The recognition criteria in the Working Draft are not operational in those circumstances.
3. We are concerned that, without further guidance, entities will develop their own policies and practical guidance on how to judge whether an obligation exists. Such actions may include entities adopting policies that the Board is trying to eliminate, such as thresholds. As a result, entities may determine the existence of obligations in different ways which will reduce comparability. Importantly, not providing guidance to address these concerns will

mean that this recognition debate will continue on an individual basis between preparers and their auditors at a significant cost to all.

4. We appreciate the challenges of trying to improve the recognition requirements for legal disputes. In the 1990s, the Canadian Accounting Standards Board had developed a new standard on contingencies to lower the recognition threshold to a “more likely than not” probability notion and to distinguish more clearly existence uncertainty from measurement uncertainty. Given the strong reaction from stakeholders, including lawyers, that new standard was never issued. Today, stakeholders continue to fail to distinguish existence uncertainty from measurement uncertainty. Therefore, the proposal to remove the probability of outflows criterion from the existing IAS 37 recognition requirements is a step forward as it helps to distinguish the two uncertainties and will improve practice.
5. Although we agree with the Board’s objective, we think that accounting requirements must take practicalities into consideration at a standards level. Standards should not be held hostage to a conceptual ideal that is unachievable. As proposed, the recognition criteria are not operational when the level of existence uncertainty is high. Given the effect the new requirements will have on preparers, lawyers and auditors and the associated cost, we think that the benefits of trying to achieve the conceptual ideal are simply not worth it.
6. Although part of the rationale for removing the threshold in the liability proposals is to obtain consistency across standards, we note that the Board and the US Financial Accounting Standards Board are proposing to use a “more likely than not” threshold in their leases project. The Boards have decided not to account for options to renew a lease and options to purchase leased assets as separate assets or liabilities. Instead, a lessee and a lessor would include an option in the recognition and measurement of a lease asset and obligation if they decide it is more likely than not the option will be exercised. We also note that in IFRSs, the term “probable” is defined as “more likely than not.” Until the Board takes action to remove or redefine the “probable” concept in IFRSs, stakeholders will continue to be required to use the “more likely than not” threshold when applying IFRSs.

7. After much deliberation, we recommend that the recognition criteria be revised to include a “more likely than not” threshold when an entity is determining the existence of a present obligation. The “more likely than not” threshold is a practical way to decide if an obligation exists when there is uncertainty, for items such as legal disputes.
8. Although consideration of obligations for which existence uncertainty is high led us to recommend adding a “more likely than not” threshold, we think that doing so does not require distinguishing between items for which existence uncertainty exists from those for which it does not. The existence of contractual and statutory obligations is clear. Therefore, we think that including a threshold will not affect the recognition of liabilities for items whose existence does not involve uncertainty.
9. We appreciate that retaining the “more likely than not” threshold as a criterion for determining the existence of all present obligations within the scope of the new liabilities standard may appear contradictory to the Board’s objective. Consequently, rather than adding this threshold to the recognition of all liabilities, the new standard could include the “more likely than not” threshold only for items that have a high level of existence uncertainty or for legal disputes.

Measurement objective (Question 1)

10. We disagree with some aspects of the proposed measurement objective and recommend the following changes to address our concerns:
 - (a) The standard should have two measurement objectives because two different measurement methodologies are used, resulting in two different outcomes. Obligations the entity intends to take actions to fulfill should be measured at the present value of resources the entity expects to incur (an expected cost approach). Obligations that the entity will settle by negotiating a cancellation or transfer should be measured at the price a counterparty or third part would demand. The Board should acknowledge that the objectives are different rather than proposing one

measurement objective and implying that both methodologies satisfy that objective when, in fact, they do not.

- (b) The standard should require an entity to select the measurement method that faithfully represents what it expects it will pay to be relieved of the present obligation, instead of the method that will result in the lowest amount (that is, the amount an entity would pay to fulfill, cancel or transfer the obligation in paragraph 36B). Selecting the method that will result in recognizing the lowest amount may underestimate what the entity will pay to be relieved of the obligation. An entity may choose to pay a higher amount because that is the most economically effective way to eliminate factors and real risks related to the liability that are not included in the expected future cash flows in some of the methods. For example, an entity may decide to pay a higher settlement to a plaintiff in a lawsuit than the amount it believes the court would most likely award in order to eliminate the risk that the plaintiff may be awarded a significantly higher amount that could financially ruin it. The entity may also decide to pay a higher settlement amount to enable senior management to generate a higher return from developing new business than fighting the lawsuit, or to mitigate the damage to the entity's reputation and ability to sell products in the future. Selecting the measurement method that faithfully represents what an entity will pay to be relieved of the present obligation would result in the accounting measurement mirroring the same factors and risks the entity's management considers in determining the course of action it will pursue to be relieved of the obligation.
- (c) The requirement that an entity be "rational" will not result in consistent measurement. What is rational to one entity may be irrational to another, because of factors such as differing tax positions. That requirement should be removed because it implies that some entities would act irrationally and pay a premium without economic justification.

Pay to cancel an obligation

11. We recommend that guidance be provided to distinguish cancellation of an obligation from fulfillment of an obligation because both terms can be interpreted broadly. “Cancel” could refer to terms specified in a contract that permit an entity to decide to terminate the contract and would involve no measurement uncertainty. “Cancel” could also be interpreted as the amount a plaintiff in a lawsuit would demand when the entity will settle a legal dispute. Following the latter approach, an entity could estimate the amount it would pay to cancel the obligation based on one possible outcome. However, until a settlement has been agreed to, the amount a plaintiff will accept is uncertain and should be measured using an expected value approach to reflect different possible outcomes.
12. In paragraph 36D, we disagree with recognizing transaction costs an entity will incur to cancel or transfer a liability as part of the measuring the price the entity will pay to cancel or transfer the obligation. We think that transaction costs are amounts paid for other services the entity receives rather than amounts paid to eliminate the obligation. Transaction costs an entity does not pay to the counterparty, or are not reflected in a current price paid to a third party should be expensed as incurred. Expensing transaction costs would be consistent with the accounting requirements for current values in IFRS 3 *Business Combinations* and IAS 39 *Financial Instruments: Recognition and Measurement*.

Obligations fulfilled by undertaking a service (Question 2)

13. We disagree with the proposal that an obligation to be fulfilled by undertaking a service at a future date should include the amounts that the entity would rationally pay a contractor at the future date to undertake the service on its behalf.
14. The stakeholders we spoke with have divided views on this issue. Some stakeholders think that the service an entity will perform is incidental to the entity’s business and should be reported as an expense. Including a profit margin in the liability measurement would result in accounting for an opportunity cost and would misstate an entity’s performance when it carries out the service. On the other hand, some stakeholders support including a profit margin because they view such services as part of the business. The profit on that activity should only be reported as income when the service has been performed. The stakeholders

who support this view think that an entity would demand a return on all the costs it incurs in providing goods and services, not just some of them. This issue is controversial because of the resulting effect on income.

15. We question why an entity should recognize a profit margin on the costs incurred to measure liabilities that will be fulfilled by performing a service when that approach is inconsistent with the proposed approach being adopted in the Board's revenue recognition project, that is, to measure onerous performance obligations at the entity's estimated direct costs.
16. To encourage the timely completion of the proposals to revise IAS 37, we recommend a practical approach. We think that an obligation that will be fulfilled by performing a service should be measured at the expected present value of the resources the entity expects to expend. When an entity will perform the service, the obligation would be measured at the costs it will incur. When an entity will hire a contractor to perform the service, the obligation would be measured at the price a contractor would charge, which will naturally include the contractor's margin.
17. To provide guidance on the type of costs an entity should or should not include in the relevant outflows for such obligations, the IFRS could adopt the guidance in IAS 16 *Property Plant and Equipment* related to directly attributable costs and to self-constructed assets.
18. Upon completion of the revenue recognition and insurance contracts projects, the Board could then assess the need to make consequential amendments to this requirement. Obligations that will be fulfilled by undertaking services should be accounted for on a consistent basis.

Obligations fulfilled by making payments to the counterparty

19. In paragraph B7, we disagree with including external legal fees or the costs of an in-house legal department attributable to that obligation as relevant outflows. Making cash payments to the counterparty refers to the method by which the obligation is to be fulfilled. The total

amount of cash paid represents the price the counterparty would demand. Therefore, consistent with the rationale provided in paragraph 12 of this Appendix, we recommend that transaction costs, including legal fees and costs of an in-house legal department, should be expensed.

Discount rate

20. We recommend that additional guidance be provided to enable entities to determine an appropriate discount rate. The Exposure Draft is silent on whether credit risk, including an entity's own credit risk, should be included in the present value of resources required to fulfil an obligation. The guidance should clarify whether a "current market assessment of the time value of money" is a risk free rate or a rate that is adjusted for changes in both the risk free rate and credit risk.
21. To be consistent with the Board's tentative decision not to update an insurance liability for changes in the risk of non-performance by the insurer, the subsequent measurement guidance for liabilities should also specify that changes in an entity's own credit risk are excluded.
22. If some entities discounted liabilities using a risk-free rate and others used a credit-adjusted rate, liabilities with similar risks would be reported at materially different amounts and not be comparable. To avoid divergent practice continuing, clear guidance is needed.

Risk adjustment

23. We agree that in all circumstances an uncertain liability should include a risk adjustment. We agree that the risk adjustment is to reflect the amount an entity would pay another party for accepting the risk that the expected present value of the outflows required to relieve the entity of the liability will differ from the present value of the actual cash flows that will be paid.
24. To provide guidance on how to determine an appropriate risk adjustment, the standard should:

- (a) Identify the different factors an entity should consider when determining a risk adjustment, such as an entity's past experience with such liabilities or the quality of the underlying inputs. We recommend that the Board consider adopting guidance similar that used by Canadian insurers on how to determine provisions for adverse deviations (risk margins).
- (b) Provide guidance on when a risk adjustment may be smaller rather than larger. For example, the risk adjustment decreases as the number of possible alternative outcomes reflected in the measurement increases.
- (c) Clarify whether the reference to "risks specific to the liability" in paragraph B14(b) is meant to refer only to the risk adjustment or is to be interpreted more broadly. In discussions, some stakeholders interpret this reference to include, for example, risk margins for technological risks, liquidity risk and credit risk. If it is to be interpreted more broadly to include these risks, the guidance should identify the possible risks an entity may need to consider.
- (d) Explain why "the adjusted discount rate is typically lower than a risk-free rate" when the risk adjustment is included in the discount rate (that is, the statement in the last paragraph of B16). Noting that the risk adjustment is an additional amount an entity would have to pay to induce a third party to accept an uncertain liability would provide clarity.
- (e) Provide examples to illustrate how a risk adjustment can be included by adjusting the relevant outflows, reducing the discount rate or adding the premium to the expected present value of outflows (paragraph B16).

Exception for onerous sales and insurance contracts (Question 3)

25. If the International Accounting Standards Board amends its proposals and requires obligations fulfilled by performing a service to be measured at the expected present value of the resources the entity expects to expend, as proposed in this response, an exception for onerous contracts would not be necessary. If such an amendment is not made, we agree with providing an exception for onerous contracts within the scope of IAS18 *Revenue* and

IFRS 4 *Insurance Contracts* for a limited time to permit entities to continue to account for such contracts following past practice until the projects to replace those standards are completed. We recommend expanding the exemption to include warranties to avoid entities changing how they account for warranties twice because the Board intends to include warranties within the scope of the new revenue recognition standard.

Convergence with US GAAP

26. We think that some of the concerns raised by stakeholders indicate a need for the International Accounting Standards Board and the US Financial Accounting Standards Board to incorporate some discussion of existence uncertainty and measurement uncertainty into the common conceptual framework. Such work would demonstrate the merits of the concepts adopted in IAS 37 and build stakeholder acceptance of those concepts.
27. At a standards level, we strongly encourage the Boards to work together to develop converged guidance rather than each taking actions that can increase the differences between IFRSs and US GAAP. The current actions of the International Accounting Standards Board to improve its recognition and measurement requirements for so-called contingent liabilities while the US Financial Accounting Standards Board has decided to improve only disclosure requirements adds further complexities in financial reporting and confusion for users.
28. Although disclosures are not part of the scope of this project to improve IAS 37, members of the Accounting Standards Board's User Advisory Council did request enhanced disclosures about the nature and risks of legal disputes at all stages of the legal process. Similar disclosure requirements are being considered by the US Financial Accounting Standards Board in its project on Disclosure of Certain Loss Contingencies. We recommend that the Board use its resources to complete the improvements to the recognition and measurement requirements in IAS 37 and in the future consider whether a new project to improve the disclosures is needed.