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

Email: commentletters@iasb.org

19 May 2010

Dear Sir David,

Re: Working draft (19 February 2010): International Financial Reporting Standard [X] Liabilities

We are writing to you to offer our comments on the Working Draft (19 February 2010): IFRS [X] *Liabilities* (the 'working draft'). Deloitte Touche Tohmatsu has commented on the International Accounting Standards Board's (the Board's) proposed amendments to the measurement of liabilities in IAS 37 in a separate letter dated 19 May 2010 (attached).

As stated in that letter, we disagree with the Board's decision to limit re-exposure of the revised IAS 37 to the measurement proposals only, and not provide constituents with an opportunity to comment on the entire draft Standard. In so doing, we do not believe that the Board has adhered to the spirit of due process. The aspects of the proposals in the 2005 Exposure Draft to which we (and many other respondents) were strongly opposed were not limited to the measurement guidance. The Board made available a working draft of the Standard (the 'Working Draft') on 19 February 2010, although it is still incomplete and does not include a Basis for Conclusions or Illustrative Examples.

We urge the IASB to consider all unsolicited comments on the sections of the working draft other than the measurement proposals. We believe that the proposed change to the recognition criteria is so significant and so inextricably linked to the measurement guidance that it cannot be understood in isolation and without putting it within the context of the entire draft Standard.

We disagree with the removal of the probability of outflow from the recognition criteria, as we believe this is a practical and well understood test for determining whether a liability should be recognised. It is also consistent with the principle in the current Framework that a liability is recognised when it is probable that an outflow of resources will result. Without this test much greater emphasis is placed on whether a present obligation exists. The assessment of the existence of a present obligation without reference to the probability of an outflow is a more subjective test and we believe the lack of coherent guidance within the proposals will make it impossible for entities to make this assessment on a consistent basis.

Furthermore, we believe that many of the requirements proposed in the working draft are not clearly communicated. We note that on 7 April 2010 the Board made available a staff paper outlining views on how the requirements of the working draft apply to lawsuits (the 'Staff Paper'). We believe the need to release this Staff Paper is further evidence that the principles within the working draft are unclear.

If the Board's overall objective in undertaking this project is consistency of application of IAS 37 requirements, we do not believe that the new proposals will genuinely achieve that aim. As discussed above, the Board has increased the subjectivity of the assessment as to whether to recognise a liability.

In conclusion, we reiterate the comments we made in response to the 2005 draft. We are not convinced that current practice is sufficiently flawed to warrant changing the fundamental approach of the current IAS 37 and we do not think that the Board's proposals will improve financial reporting. Our detailed responses to the questions raised in the Invitation to Comment are noted in the Appendix to this letter.

Our detailed comments on the working draft are included in the Appendix to this letter.

If you have any questions concerning our comments, please contact Veronica Poole in London at +44 (0) 207 007 0884.

Sincerely,

A handwritten signature in black ink, appearing to read 'V Poole', written in a cursive style.

Veronica Poole
Global IFRS Leader – Technical

Appendix

Scope

The Board has not yet approved illustrative examples for the draft Standard. The Working Draft has suggested the deletion of some examples previously included within IAS 37, in particular examples 4, 4B and 18 on warranties, 5 on a single guarantee, 9 on a refunds policy and 12 on onerous contracts. This exclusion is on the basis that these types of liabilities will be within the scope of the new standards on revenue recognition, insurance and leases. We believe the Board should clarify that, until such time as IAS 17, IAS 18 and IFRS 4 are revised, these types of liability remain within the scope of IAS 37. Therefore the examples should be retained, with amendments as appropriate.

Recognition – probability of outflow

The definition of a liability in paragraph 8, with its reference to settlement which is ‘*expected* to result in an outflow from the entity of resources embodying economic benefit’ is consistent with the definition in paragraph 49(b) of the Framework. Paragraph 91 of the Framework also refers to recognition of a liability ‘when it is *probable* that an outflow of resources embodying economic benefits will result’, suggesting that, within the Framework, ‘expected’ is synonymous with ‘probable’. This is consistent with the commonly understood meaning of ‘expected’, which requires a particular degree of certainty. However, the analysis in paragraph 22 of the Working Draft contradicts both the Framework and common usage by interpreting the word ‘expected’ as meaning only *capable* of resulting in an outflow. Such an interpretation could only be consistent with a definition of a liability that required only that it ‘*may* result in an outflow’.

Other paragraphs within the Working Draft appear to contradict paragraph 22 in that they imply the level of probability of outflow *is* an important consideration. For example, paragraph 19 concludes that ‘in some situations, the available evidence might suggest that the probability of an adverse outcome is so low that the liability is immaterial’. Further, paragraph 51 requires disclosure where ‘an entity has judged that it does not have a liability, unless the possibility of any outflows of resources is remote’.

Currently the requirements of IAS 37 are consistent with the definition of a liability in the Framework in that it requires recognition when:

- an entity has a present obligation as a result of a past event;
- it is probable that an economic outflow of resources embodying economic benefits will be required to settle the obligation; and
- a reliable estimate can be made of the amount of the obligation.

We understand that, within the Working Draft, the Board is stating that the assessment of uncertainty in determining whether to recognise a liability should be encompassed in the assessment of the present obligation and not in the assessment of the outflows (i.e. uncertainty about the present obligation affects recognition, uncertainty about the outflows affects measurement). However, we believe the proposed changes create the following problems in terms of practical application:

- Under the current IAS 37, the identification of a past event and the assessment of the ‘probable outflow’ provide a practical test to determine whether a present obligation exists and a liability should be recognised. The proposed present obligation test without an assessment of ‘probable outflow’ is more subjective and difficult to apply.
- In circumstances where there is uncertainty about the existence of a present obligation, we find the requirement to weigh up the available evidence vague. Paragraphs 13 to 16 of the working draft do not provide clear guidance on whether there is a threshold with respect to assessing the existence of a present obligation.
- As indicated in the Staff Paper, typically in a disputed lawsuit, it is uncertain whether the defendant has a present obligation. In reaching a judgement on whether there is a present obligation, it is appropriate to focus on the role of financial reporting which is to reflect the possible financial consequence. We therefore believe that the assessment of the probability of

outflows should be a primary factor in determining the existence of a present obligation and the recognition of a liability.

- The Working Draft (and, in particular, paragraph 22) fails to recognise the correlation between a present obligation and an outflow of assets. For example, if there is a low probability of an outflow there is usually a low probability of a present obligation (i.e. there is a high correlation in this direction). However, the opposite may not always be true. There may be a high probability of an outflow but a low probability of a present obligation. For example, it may be probable that an entity will settle with a customer but there is inconclusive evidence to determine that an authority, at the end of a process, would require the entity to pay the counterparty. Under the current IAS 37, the existence of a claim gives evidence of a possible present obligation (as indicated in paragraph 15) which, coupled with the probability of the cash outflow, provides a practical test to determine whether a present obligation exists and a liability should be recognised.
- Paragraphs 13 to 16 also do not effectively address the unit of account. That is, are all items required to be assessed separately or can like items be pooled? For example, an entity with many claims may assess each claim separately and determine that for each individual claim there is not sufficient evidence to assert that it is probable there is a present obligation. However, looking at the pool of similar claims, the entity may have historical information that indicates that a portion of such claims are found to be valid and therefore a portion of the pool represents a present obligation. If IAS 37 is amended, we believe this should be addressed within the final Standard.
- In a scenario in which a present obligation is identified for which the likelihood of an outflow is very low, we believe such an 'obligation'/outcome is dealt with more appropriately through disclosure, as in the current IAS 37.

We do not believe that the Staff Paper has clarified these issues. The Staff Paper states entities would not recognise liabilities for legal claims that lack merit and that an obligation arises only from an act of wrongdoing by the entity (paragraph 20). However, paragraph 13 suggests that an entity may recognise a liability in a situation where it has not admitted wrongdoing but believes, based on past experience, that it will settle the claim out of court (i.e. that there is probability of outflow). This paragraph appears to undermine the conclusion elsewhere that an obligation arises only from an act of wrongdoing. It also appears to be implicitly applying a probability of outflow test as a practical means of determining whether a liability should be recognised.

The food poisoning example (IE 1) states that the entity has a present obligation to compensate a customer *if* they were harmed by the entity's food containing a harmful contaminant. There is uncertainty whether the customer was harmed by the entity's food (e.g. the customer was not harmed at all, the customer was harmed by other food they ate, or the customer was harmed by an airborne virus). If the likelihood that the customer was harmed by the entity's food was 51% does the entity have a present obligation? Would the answer be different if the likelihood was 49% (or 10% or 90%)? The IASB members and staff have indicated in their webcasts that the weighing up of evidence to determine whether a present obligation exists is an assessment of likelihood or probability. However, the draft words do not reflect that a level of certainty is required.

Distinguishing a present obligation from a business risk

Paragraph 15 states that the start of legal proceedings against an entity is not in itself an event that gives rise to an obligation. In the food poisoning example (IE 1), the 2005 Exposure Draft stated the start of legal proceedings *was* a 'past event' that obliged the entity to 'stand ready' to perform as the court directs. Hence the entity had a 'stand ready' obligation. The Working Draft states that this original conclusion was wrong – an entity does not have a liability to 'stand ready' in this scenario. The Board's suggestion is to retain the example but to state that no liability is recognised. At the moment, the Working Draft does not say whether this is because the entity does not believe the food was poisonous or because the lawyers do not think the entity will be found liable. The Staff Paper

appears to conclude that it is the former. However, as highlighted above, we believe the Staff Paper is also unclear on this issue and, in any case, is not an official pronouncement of the Board.

It is unclear what a ‘stand-ready’ obligation represents in a non-contractual context. The responsibility described in paragraph 19 to make good another entity’s environmental obligation would surely only arise if a guarantee had been given, which would be outside the scope of IAS 37 and any replacement Standard. Consistent with the tentative decision reached by the Board in the March 2007 discussions on the draft Standard we believe the term should be abandoned.

Consistency with other standards

In the 2005 Exposure Draft, the Staff Paper and during IASB webcasts, the removal of the probability of outflow criterion has been justified on the basis of aligning IAS 37 with IFRS 3 (2008). We do not find this argument convincing. IFRS 3 (2008) takes an underlying fair value approach and stipulates the recognition and measurement requirements for a particular event, a business combination. It is not consistent with other ‘cost’-based IFRSs, for example IAS 38 and the recognition of internally generated intangible assets. We believe that IAS 37 should continue to apply a cost-based approach.

Reimbursement rights

We do not understand the final sentence of paragraph 41 and it is not clear to us why this sentence has been included in a section on reimbursement rights.

Disclosures

Paragraph 16 introduces a requirement to make certain disclosures (as detailed in paragraph 51) where an entity has judged that it does not have a liability. However the scope of the working draft only extends to situations where there is a liability and so these requirements will never apply.

Paragraph 52 requires an entity ‘to disclose information that identifies the current and expected future costs of its restructuring activities’. However, no definition of restructuring activities is given within the working draft. In fact the purpose of Appendix C is to clarify that restructuring provisions no longer exist – an entity must look to the individual costs to determine whether a liability can be recognised. It is not clear whether this disclosure is required where a liability has been recognised or where no liability has been recognised or in both scenarios. Also it is not clear what the intended meaning of ‘expected’ future costs is – specifically, is any degree of certainty implied?

We agree with the decision that liabilities for those individual costs which are typically described as ‘restructuring costs’, should be recognised on the same basis as if those costs arose independently of a restructuring decision. However, we do not believe that Appendix C makes this statement in a particularly clear or succinct way. In particular, we disagree with the final sentence of C4 that, in all cases, the announcement or implementation of a restructuring plan does not result in an obligation. We believe that, if costs need to be assessed separately, when an entity announces or starts to implement a restructuring plan, it needs to consider for each type of cost whether a liability arising from a legal or constructive obligation exists.

Transition

There is currently no guidance on the transitional arrangements. We believe it is important to address this point. The Board should consider providing some type of practical expedient for dealing with the other side of the entry for an existing liability that changes in value due to the new measurement provisions. If the corresponding debit entry is an asset, for example as in the case of a decommissioning liability, we do not think it is practical to require constituents to work backwards to try to figure out where the various debits and credits would have gone if the revised standard had always been applicable. Instead we believe the Board should consider providing transitional relief such as that provided within IFRIC 4.