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Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London
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Email: commentletters@iasb.org

19 May 2010

Dear Sir David,

Re: Exposure Draft ED/2010/1 *Measurement of Liabilities in IAS 37 - Limited re-exposure of proposed amendments to IAS 37*

Deloitte Touche Tohmatsu is pleased to comment on the International Accounting Standards Board's (the Board's) proposed amendments to the measurement of liabilities in IAS 37.

We disagree with the Board's decision to limit re-exposure of the revised IAS 37 to the revised measurement proposals only, and not provide constituents with an opportunity to comment on the entire draft Standard. 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. Furthermore, to express a view on the proposed measurement guidance in the 2010 Exposure Draft, it is fundamental that the scope, definitions and recognition criteria, to which this guidance is expected to apply, are understood. The Board made the entire draft Standard publicly available on 19 February 2010 but has given respondents no formal opportunity to comment on other aspects of the draft Standard, which may have a bearing on the measurement guidance if adopted as proposed. In so doing, we do not believe that the Board has adhered to the spirit of due process.

We comment in a separate letter (attached) on other aspects of the draft Standard. However, we believe that the proposed change to the recognition criteria is so significant and so inextricably linked to the measurement guidance that it also warrants comment here.

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.

With respect to the measurement proposals themselves, we fundamentally object to the requirement to apply a probability-weighted average expected value technique to the measurement of all liabilities within the scope of the proposed Standard. We agree that the expected value may be the most appropriate measure for liabilities for which the population is large and homogeneous. However, for single discrete items, such as a significant lawsuit, we believe the proposed approach will be impractical to apply, difficult to explain to users of the financial statements and require the measurement of liabilities at amounts that will never be the final settlement amounts and, as such, are unlikely to convey useful information to users regarding the final settlement. Ultimately, this proposal will result in less relevant or decision-useful information being included in the financial statements.

Furthermore, we have significant concerns about the detailed guidance to the measurement proposals in Appendix B; in particular, the requirements to add a risk adjustment and, where the obligation is to be fulfilled by undertaking a service, a hypothetical margin to the costs that an entity will incur if it performs the services itself. We discuss these points further in the attached Appendix to this letter.

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 addition, the limited guidance on the application of the measurement methodology itself and the explicit allowance in paragraph B4 of the proposal to short cut statistical techniques will create divergence in practice. Yet, because the methodology is described as an 'expected value technique', the number recognised in the financial statements will imply scientific precision where there is none. Further diversity will be created through different interpretations of how to apply the risk adjustment and profit margin.

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 responses to the invitation to comment questions 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,

Veronica Poole
Global IFRS Leader – Technical

<u>Appendix: Invitation to Comment</u>

Overall Requirements
Question 1
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?

If 36B had no reference to Appendix B, the measurement objective set out in paragraphs 36A-36D, in particular the 'lowest of' notion, implicit in the measurement of a liability at the amount an entity would rationally pay, could comfortably sit alongside the current IAS 37 requirements. However, we strongly disagree with a number of the specific requirements in Appendix B and therefore, overall we do not support the requirements proposed in paragraphs 36A-36F. We do not believe there is a need to change the current general approach to measurement in IAS 37. We disagree with the Board's assertion in BC3 that the current measurement requirements are ambiguous and, as a result, practices vary. We believe that the wide variation in the nature of items that fall within the scope of IAS 37 justifies different measurement methodologies.

<u>Expected value technique</u>
Fundamentally we do not believe that the expected value technique as explained in B2-B4 is an appropriate methodology for the measurement of all liabilities within the scope of IAS 37. The Board has concluded in its Exposure Draft on the Conceptual Framework for Financial Reporting: Chapters 1 and 2 that financial reporting has decision-usefulness when it provides information about the entity's ability to generate net cash inflows (OB9-11) and has predictive value (QC4). We believe the expected value technique is only predictive of net cash outflows for large populations of similar but independent items. We agree with the statement in paragraph 24 of the Staff Paper on liabilities arising from lawsuits, which the Board made available on 7 April 2010, that capital providers want information on all of the entity's existing obligations and the range of possible future cash flows for each. However, for single discrete items, a single figure can never portray all the information necessary for a user to assess the uncertainties of the liability. The use of expected value implies that all information can be encapsulated in a single figure, which, in turn, implies a level of accuracy in determining probabilities that does not exist in practice. It is acknowledged in paragraph B4 that the proposals permit a practical limit to the number of outcomes that must be considered and therefore that there is a limit to the level of accuracy expected in this 'statistical' number. In practice it will be difficult to know how many outcomes need to be considered to provide a reasonable estimate. We consider disclosure of information on the uncertainties and the range of outcomes together with a predicted most likely cash outflow is more useful.

Therefore, we support the current requirements of IAS 37 which permit a most likely outcome for the measurement of a single obligation. For large populations of similar items an expected value technique may be consistent with the objective of the most likely outcome. The guidance in IAS 37.40 provides a good safeguard to ensure that entities do not measure a liability at the most likely outcome without considering other possible outcomes. We believe that the work required to determine the most likely outcome and a broad range of other possible outcomes is not as onerous as the work that would be required to measure a liability on an expected value basis. We therefore disagree with the Board's conclusion in BC16.

<u>Risk adjustment</u>
There is a number of other requirements within Appendix B which we believe lack clarity. In particular, we are unsure what the risk adjustment in B15 represents. If this adjustment is for modelling risk, then it may be appropriate to the extent that a statistical model has been used to determine a distribution curve of possible outcomes. However, the Exposure Draft does not mandate the use of statistical techniques and B4 explains that a limited number of discrete outcomes and

probabilities can often be considered to estimate the expected value. We disagree with an adjustment for modelling risk where a statistical model has not been used, as we believe that the risk that actual outflows might differ from those expected has already been reflected through the probability weighting of the discrete outcomes.

B15 explains that the risk adjustment 'measures the amount, if any, that the entity would rationally pay in excess of the expected present value of the outflows to be relieved of this risk'. We question whether the addition of such an amount to the expected present value of the outflows has changed the measurement of the liability from the 'present value of resources required to fulfil the obligation' to the 'amount that the entity would pay to transfer the obligation to a third party' and is thus inconsistent with the 'lowest of' notion. We have the same concern as the alternative view expressed in AV5 that the lack of guidance regarding the circumstances in which a risk adjustment should be included and how it should be determined is likely to lead to significant diversity in practice. This would seem to be inconsistent with the Board's stated objective in undertaking this project of reducing a perceived ambiguity. Alternatively, the lack of guidance could lead to the addition of a 'standard' risk adjustment by entities. While, arguably, this would be a consistent application of the draft Standard, it would result in meaningless financial information.

We draw the board's attention to our comment letter on the discussion paper *Credit Risk in Liability Measurement.* There we stated that credit risk should not be reflected in the measurement of a liability if the customary terms and conditions of that liability do not consider the credit risk associated with the liability, for example decommissioning liabilities and contingent obligations for litigation.

Associated costs

A second area in need of improved guidance is the requirement to include associated costs in the measurement of relevant outflows for obligations fulfilled by making payments to the counterparty. B7 states that the relevant outflows include 'associated costs, such as external legal fees or the costs of an in-house legal department attributable to that obligation'. We agree that associated costs should be included. However, we believe it is not clear whether, in respect of in-house costs, this is an incremental or attributable cost model. We would support an incremental cost approach.

Subsequent and future events

The final sentence of B11 refers to the evidence of additional information provided by events after the reporting period. We believe it should refer not to 'the ***obligation*** existing at the end of the reporting period', but to '***conditions*** existing at the end of the reporting period.'

Paragraphs B12 and B13 provide guidance on the extent to which an entity takes into account future events that might affect the outflows of resources required to fulfil the present obligation. Distinction is made between those future events that might affect the outflows of resources without changing the nature of the obligation, for example technological advances, and those which change or discharge the present obligation or create new obligations, such as a change in legislation. We do not understand the rationale behind this distinction between new technology and new legislation. The proposals imply that if it is expected that changes in technology will occur, they should be reflected as an outcome in the expected value measurement. However, changes in legislation cannot be factored in when expected, but only when enacted. The proposals would be particularly difficult to apply in situations when technological advances are expected due to future expected changes in legislation and it therefore becomes difficult to determine the extent to which the future impact of these should be included in the outflows of resources. The proposals imply little restriction on the assumptions of changes in technology that can be factored into measurement and we question the reliability of the resulting figures. We find the guidance in the current IAS 37.48-50, which requires the inclusion of the impact of future events where there is sufficient objective evidence that they will occur, more helpful.

Obligations fulfilled by undertaking a service
Question 2
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 fulfil 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 object to the proposal in B8. By requiring an entity to measure an obligation which will be fulfilled by undertaking a service at the amount the entity would rationally pay a contractor to undertake the service on its behalf, the Board has shifted to a value or opportunity cost concept in measuring the present value of the resources required to fulfil the obligation. B8 is intended to provide guidance on the application of 36B, but is actually in conflict with the objective of measuring a liability at the 'lowest of' amount. We also disagree with the statement in BC21(d) for the same reason. We believe that any replacement for IAS 37 should continue to apply a cost-based approach to the measurement of non-financial liabilities and we believe that the costs of undertaking a service would include all directly attributable costs.

If an entity expects to fulfil an obligation by undertaking the service itself, measuring that obligation at the price a contractor would charge to undertake the service (or at the price that entity would charge another party) does not result in decision-useful information about cash outflows. It is inconsistent with the measurement requirements of the Framework (Fw100(d)) that 'liabilities are carried at the discounted value of future net cash outflows that are expected to be required to settle the liabilities in the normal course of business'.

The requirement to include a hypothetical margin in the measurement of a liability that will be settled based on internal resources may distort the recognition of profit in the periods in which the liability is initially recognised or, if capitalised into an asset, over the useful life of the asset and when it is derecognised. It results in less relevant financial information and seems to require the recognition of amounts that do not meet the definition of a liability. Take the example of decommissioning costs and an entity with a single power station. Decommissioning costs will be added to the initial carrying amount of the asset and amortised over the life of the power station. The price charged for power over the life of the station will include an amount to recover these costs. When the power station has ceased to generate power and is in the decommissioning phase, we do not agree that an entity should recognise some profit deferred during the operating phase. In our view not all activities should be considered profit oriented. In particular, we do not believe that entities would consider that decommissioning activities are part of revenue generating activities, just as under current Standards the initial construction phase of, for example, a self-constructed power station is not profit generating, and we are not aware of any proposals by the Board to change this.

We believe that there are cases where an entity may have a choice of either making payments to a counterparty or undertaking a service itself. The proposals would lead to different measurement principles for these two choices. It is not clear in these cases whether the liability should be for the lower amount or should be a probability-weighted average of the two choices.

Finally, we agree with the alternative view expressed in AV2(c) that there is a lack of guidance about what constitutes a market and how to determine the margin when there is not a market for the service. We therefore disagree with the Board's conclusion in BC21(a) that this approach will reduce subjectivity ensuring similar liabilities are measured at similar amounts and we believe that, in fact, it may have the opposite effect, giving rise to more diversity in practice.

Exception for onerous sales and insurance contracts
Question 3
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 fulfil its contractual obligations, rather than the amounts the entity would pay a contractor to fulfil 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?

As stated in our response to question 2, we do not agree with the requirements of paragraph B8 to measure an obligation to be fulfilled by undertaking a service at the amount the entity would pay a contractor to undertake the service on its behalf. We therefore disagree that a limited exception, as proposed by paragraph B9, is required for onerous contracts on the basis that we believe all obligations to be fulfilled by undertaking a service should be measured at the costs the entity expects to incur to fulfil its obligation, rather than by reference to a contractor price.

However, if the Board decides to proceed with the proposal in paragraph B8, we believe that the exception in B9 will be necessary and should also be extended to all obligations that are currently in the scope of IAS 37 but which we expect will be in the scope of a revised IAS 18 or IFRS 4 (for example warranty provisions).