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October 28, 2005

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
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Dear Sirs,

Comments on Exposure Draft of Proposed Amendments to IAS 37 "Provisions, Contingent Liabilities and Contingent Assets" and IAS 19 "Employee Benefits"

The Accounting Standards Board of Japan (ASBJ) is pleased to comment on the Exposure Draft of Proposed Amendments to IAS 37 "Provisions, Contingent Liabilities and Contingent Assets" and IAS 19 "Employee Benefits"(the Exposure Draft). The views expressed in this letter are those of International Issues Standing Committee of the ASBJ.

We disagree with elimination of the 'probability recognition criterion' and the term 'contingent liability' and disagree that an expected cash flow approach is an appropriate basis for measuring non-financial liabilities in all cases because we have concerns as follows:

- The 'stand-ready unconditional obligation', which is the key concept of the proposed amendments, is not clearly defined.
- We do not believe that there is a significant problem that requires amendment of the existing Standard. In our view, difference in accounting treatment between contingent liabilities acquired in business combinations and those generated internally is reasonable and there is no need of conformity.
- Practical difficulty would arise from elimination of the 'probability recognition criterion' and adoption of the expected cash flow approach to all cases.

We would like to make comments on each question in details as follows.

1. Contingent liabilities (Question2)

We disagree with elimination of the term 'contingent liability' for the following reasons.

(1) The ambiguity of the notion of 'an unconditional obligation to stand ready to fulfill a conditional obligation'

The Exposure Draft explains that liabilities arise only from unconditional obligations and that most of liabilities previously described as contingent liabilities are 'unconditional obligations to stand ready to fulfill conditional obligations' and are recognized as liabilities. To apply this notion to practice, a clear definition of 'an unconditional obligation to stand ready to fulfill a conditional obligation' is necessary.

However, it is not quite clear what kind of an obligation is 'an unconditional obligation to stand ready to fulfill a conditional obligation'. It indeed describes the criteria to recognize a non-financial liability and provides illustrative examples. Nonetheless, some ambiguity remains and we are uncertain about the following points:

a) ***Example 2: Potential lawsuit*** shows a case that the hospital is aware that it made a mistake and is highly likely to be filed and found guilty of negligence. However, we are uncertain about whether a liability should be recognized if it is unclear whether the patient's death is attributable to malpractice and it is possible but not probable that the hospital will be filed and found guilty of negligence.
b) Even if the hospital does not believe that the patient's death is attributable to malpractice, there may be the possibility of the legal proceedings. In such case, is the patient's death (or the surgery done) deemed a triggering event and should a liability be recognized?

(2) **Different conditions in contingent liabilities recognized in business combinations**

Paragraph BC22 notes that contingent liabilities would be treated consistently, regardless of whether they are acquired in a business combination or generated internally, if the analysis of such items is refined. However, we believe that it is reasonable that accounting treatments for such obligations may differ depending on whether they are acquired in a business combination or generated internally because conditions relating to recognition and measurement are significantly different. In cases of business combinations, litigation obligations with low probability may be evaluated in the process of price negotiation between acquirers and acquirees and reflected in the purchase price. Such liabilities can be considered as assumed in exchange for consideration, unlike those generated internally because they are reflected in the purchase price. In addition, reliability of measurement is much higher than cases of internally generated ones because the valuation is determined in arm's length price negotiation. Therefore, we believe that difference in accounting treatment between them is reasonable and there is no need of conformity.

(3) **Usefulness of contingent liabilities as off-balance-sheet items**

Paragraph 27 states that an entity will be able to determine a reliable measure of a liability except in extremely rare cases.

However, we do not believe that the cases where non-financial liabilities cannot be reliably measured are 'extremely rare'. In particular, for a liability arising from lawsuit that does not have many similar cases, it is often the case that it cannot be reliably measured because it is impracticable to reasonably estimate the probabilities of possible outcomes.
Furthermore, we would like to note that certain items that are not recognized as a liability due to the probability recognition criteria under the existing IAS 37 would meet the recognition criteria as unconditional obligation under the proposal of the Exposure Draft. In those cases, reliability of measurement is generally considered to be low.
Considering these matters, we believe that 'contingent liabilities' as off-balance-sheet disclosure items would commonly exist and it is not appropriate to eliminate that notion.

2. Probability recognition criterion (Question 5)

We disagree with elimination of the concept of the probability recognition criterion.

The Exposure Draft proposes that the probability recognition criterion be omitted from the Standard and that uncertainty about the amount and timing be considered in measurement. However, reliability of estimates of the probability is critically dependent on the frequency of similar events. In cases of warranty on products of manufacturing companies that have large population, the aggregate cost of warranty can be reliably measured even if the probability of occurrence for individual product is low. Recognizing such warranty as a liability does not cause any practical problems. On the other hand, in cases of obligations such as those arising form lawsuits, each individual item may have different nature and substance. Measurement of such items, in many cases, lacks sufficient reliability and brings problems in both usefulness of information to users and preparers' costs. Considering that such obligations generally fail to meet the probability recognition criterion under the existing IAS 37 but would be recognized under the Exposure Draft, we doubt the usefulness of the proposed approach.

We believe that, for events that occur infrequently, it is appropriate to recognize liabilities only when the occurrence of the events is probable.

3. Measurement (Question 6)

(1) **Expected value and the most likely outcome**

The Exposure Draft states that an expected cash flow approach is an appropriate basis for measuring a non-financial liability for both a class of similar obligations and a single obligation.

However, we believe that measuring a single obligation at the most likely outcome approach would be sometimes more relevant than an expected cash flow approach. In our opinion, measuring at the most likely outcome may provide more useful information in cases where the probability of occurrence is relatively high.

For example, when an entity has an eighty percent chance of outflows of economic benefits and a twenty percent chance of no outflow, measuring the liability with the amount of a hundred percent may be more relevant than measuring at the amount of eighty percent.

(2) **Measurement attributes**

The Exposure Draft provides requirement to be applied in accounting for all non-financial liabilities. Most of non-financial liabilities relate to non-financial investments* and they should be regarded as a part of business investments, not financial investments.

In our view, the measurement method for non-financial liabilities proposed in the Exposure Draft would sometimes fail in reflecting economic substance due to the following provisions:

a) The interest rate used for discounting shall be the current rate at each balance sheet date.

b) A non-financial liability shall be measured at the amount that the entity would rationally pay to settle the present obligation or to transfer it to a third party on the balance sheet date. And it is mentioned that contractual or other market evidence can be used in some cases.

With regard to a) above, we believe that it is irrelevant to recognize changes in present value of liabilities due to changes in market interest rates in profit or loss, unless those liabilities are part of financial investment activities. In cases of non-financial liabilities, changes in market interest rates would not change the expected future cash flows because it is highly unlikely that they would be settled before maturity. Following the same logic as held-to-maturity

* In our view, assets are classified into financial investments and non-financial (business) investments according to the purpose of the investment. Non-financial investments are investments aimed at obtaining the results through operating the business and financial investments are investments aimed at obtaining gains from changes in the market price.

investments, such liabilities should be measured using the amortized cost method.

And with regard to b) above, we have concern about use of market price for non-financial liabilities. In our view, considering that an entity owes non-financial liabilities as part of business investments, measurement based on the assumption that they are transferred to a third party would not necessarily reflect economic substance. Furthermore, we believe that remeasurement of such liabilities at market price is inappropriate because it would result in the effect of changes in market interest rates being mixed in profit or loss.

4. Non-financial liability for a cost associated with a restructuring (IAS 37 Question 9, IAS 19 Question2)

We are uncertain about consistency between guidance on the definition of a liability (paragraphs 12-21 of the proposed IAS 37) and guidance on recognition criteria for a liability for restructurings (paragraphs 62-65 of the proposed IAS 37 and paragraphs 137 and 138 of the proposed IAS 19).

Paragraph 64 stipulates that an entity shall recognize a liability for a cost associated with a termination of a contract resulting from a restructuring when the entity terminates a contract or notifies a counterparty of termination. It follows that the entity shall not recognize any liabilities when the entity has announced the restructuring plan but has not notified the termination to the counterparty, even if the counterparty can obviously expect the termination of the contract and the entity has no or a little discretion to avoid the obligation of the termination. However, according to paragraph 15, it seems that a constructive obligation exists and a liability shall be recognized in such case.

Also, according to paragraphs 137 and 138 of the proposed IAS 19, the entity shall not recognize any liabilities regarding termination benefits when the entity has not communicated termination to affected employees, even if there is no doubt that the entity will execute the restructuring plan because the entity executed restructuring plans in the past as they were announced. However, according to paragraph 15 of the proposed IAS 37, it seems that a constructive obligation exists and a liability for the termination benefits shall be recognized.

We suggest that the relationship between guidance on the definition of a liability and guidance on recognition criteria for a liability for restructurings should be made clearer from the perspective of internal consistency of the standard. The Exposure Draft explains that the amendments to the treatment of restructuring costs were made as a result of short-term convergence undertaken by the IASB and the FASB. However, as noted above, we do not believe that a notification to the counterparty should be prerequisite for recognition of a liability because even in cases of contract termination costs or termination benefits there may be situations where a constructive obligation is considered to exist even though the counterparty is not yet notified.

We hope that our comments will contribute to the work of the IASB in arriving at its final decision.

Best Regards,

Ikuo Nishikawa
Chairman, International Issues Standing Committee
Vice-Chairman, Accounting Standards Board of Japan