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Dear Sirs,

Comments on IASB Exposure Draft "Measurement of Liabilities in IAS 37"

May 19th, 2010
Accounting Standards Board of Japan

We appreciate the IASB's long-running efforts on the Liabilities project and welcome the opportunity to comment on the Exposure Draft "Measurement of Liabilities in IAS 37" (herein after referred to as "the ED").

Although the ED limits the scope of questions, we consider that removing the probability criterion and requiring the measurement using the expected value are significant issues closely related to the questions in the ED. Therefore, we express our views on those issues before responding to the ED's questions.

<u>Removal of the probability criterion and measurement using the expected value</u>

1. **We disagree with removing the probability criterion and requiring the measurement using the expected value. We believe that the probability criterion in recognition of liabilities should be retained and measurement using the most likely outcome may be more appropriate for some obligations. Therefore, amending the existing IAS 37, which permits the measurement using either the most likely outcome or the expected value, to the Working Draft would result in improvement of the quality of financial reporting. Retaining the requirements in the existing IAS 37 would be more appropriate.**

2. The existing IAS 37 uses different measurements according to the nature of obligations being measured. For the provision involving a large population of items, the obligation is estimated by the expected value (paragraph 39 of IAS 37). It also states that the individual most likely outcome may be the best estimate for a single obligation (paragraph 40 of IAS 37). In contrast, the ED would remove the probability criterion and require measurement using only the expected value

irrespective of the nature of the obligation being measured. Accordingly, it would require even a single obligation such as that for a lawsuit, of which situation varies with each case, to be measured using the expected value. Applying such an approach in the ED involve problems concerning measurements using the expected value (paragraphs 3 and 4 below) and those concerning the removal of the probability criterion (paragraphs 5 and 6 below).

3. As required by paragraph B3 of the ED, measurement of the expected value would need indentifying each possible outcome and making an unbiased estimate of the probability of each outcome. However, those estimates for a single obligation would often involve serious difficulties. Measuring such an obligation using the expected value by forcing prediction of a probability distribution would inevitably result in an arbitrary measure. As reliability would not be ensured by such measurement, there is a concern that it might not provide useful information for users of financial statements to predict future cash flows and thus not contribute to any improvements of the quality of financial reporting.

4. Even if all of the possible outcomes and their probabilities were known, there would be cases where the expected value seems unlikely to be more useful than the most likely outcome. For example, assume that management considers a certain amount of outflow (e.g. 100) is expected with a very high probability (e.g. 95%) and a much larger amount of outflow (e.g. 100,000) is expected with a very low probability (e.g. 5%). In this case, whereas the most likely outcome would be 100, the expected value would be 5,095. Reporting the liability at the amount of 5,095, which is largely different from the highly probable outcome of 100, might rather mislead users of financial statements than providing information useful in predicting future cash flows.

5. Removal of the probability criterion would result in requiring recognition of an obligation with low probability of an outflow of resource. However, when probability of an outflow is low, it is often the case that reliable measurement of possible outcomes and their probabilities is very difficult. The probability criterion helps to ensure reliability of measurement by restricting recognition of such an obligation.

6. On the other hand, paragraphs 13 through 15 of the Working Draft state that the entity shall judge whether an obligation exists, taking into account all available evidence such as experience of the entity or other entities and opinions of experts.

Such guidance would result in an obligation with a probability lower than a certain level not being recognized and have an effect similar to the probability criterion. However, it would not necessarily enable more objective judgment of whether to recognize a liability than the probability criterion and thus would not be an improvement to the existing treatments.

7. IASB Staff Paper "Recognising liabilities arising from lawsuits" dated in April 7, 2010 explains that even without the probability criterion an obligation does not exist unless the claim is valid and entities would not necessarily recognise a liability for every lawsuit. However, such judgment of whether an obligation exists would be in effect similar to that of probability and there is a concern that the judgment might become less objective than the probability criterion.

Question 1 – Overall requirements

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 paragraphs.

Dou you support the requirements proposed in paragraph 36A-36F? If not, with which paragraphs do you disagree and why?

Initial measurement

8. **We disagree with the measurement objective set out in paragraph 36A. In order to provide information useful for predicting future cash flows, a liability within the scope of the ED should be measured at an estimated present value of the outflow required to ultimately settle the obligation. We suggest that paragraph 36A should be modified as below, to delete 'at the end of the reporting period' and to read "the resources required to fulfil the obligation" in paragraph 36B (a) as the cost rather than the value.**

9. For the obligation fulfilled by making payments to the counterparty, measurement would be the same whether it is measured by the cash flow or the value. However, for the obligation fulfilled by undertaking a service, the measurement would differ depending on whether it is measured by the cash flow or the value. In fulfilling such an obligation, the entity has an alternative to outsource the service to a third party or undertake the service by itself and would rationally choose whichever is more advantageous. From the view of prediction of future

cash flows, measurement of liabilities should reflect the management intent based on such value-maximizing behaviour.

10. The measurement objective we suggest above is consistent with IAS 36, which measures an impaired asset at the higher of its value in use and its fair value less costs to sell. In other words, according to our suggestion, a liability would be measured at the lower (i.e. more advantageous) of the present value of the costs to fulfil the obligation (the mirror image of value in use) and the amount that the entity would pay at present to cancel or transfer the obligation (the mirror image of fair value less cost to sell). Both of those amounts can be described as "the present value of the outflow required to ultimately settle the obligation".

11. On the other hand, paragraph B8 of the ED requires that an obligation fulfilled by undertaking a service should be measured at the estimated price that a contractor would charge to undertake the service on the entity's behalf. As a result, the overall approach of the ED is equivalent to that of measuring an impaired asset at its fair value, ignoring its value in use. Paragraph BC10 (b) states that the proposed measurement objective is consistent with IAS 36. However, the measurement objective we suggest above would be more consistent with IAS 36, which reflects the value-maximising behaviour of an entity, and more appropriate as a measurement objective for liabilities.

12. Furthermore, paragraph B8 ignores the possibility that an entity can reduce cash outflows by undertaking the service by itself, when it expects to do so at a lower cost than a third party. This would be inconsistent with the explanation that the word rational implies a 'lowest of' notion (paragraph BC10 (a)) and result in recognition of an excessive amount of expense.

<u>Subsequent measurement</u>

13. We disagree with the proposal in paragraph 36B. This paragraph requires that the interest rate used for discounting shall be the current rate at each reporting date. However, in cases of non-financial liabilities, changes in market interest rates would not change the expected future cash flows because settlement before maturity is highly unlikely. Following the same logic as held-to-maturity investments, such liabilities should be measured at the amortized cost.

<u>Consideration of risk</u>

14. We comment about consideration of risk described in appendix B referred by

paragraph 36B.

We agree the risk adjustment set out in paragraphs B15 through B17 as long as we assume the entity's risk-averse preferences. However, we would like to point out that its implementation in practice is significantly difficult. Adding 5% as risk adjustment, as shown in the Illustrative Example, may be arbitrary and we are concerned about how the risk adjustment should be applied in practice because the ED does not include the specific guidance.

15. In addition, although the ED does not specify the treatment of credit risk, we believe that it should be clarified based on the consideration of comments on the Discussion Paper "Credit Risk in Liability Measurement" issued in June 2009. In our opinion, measurement of liabilities in IAS 37 should not incorporate credit risk, as we have commented on the Discussion Paper above.

Question 2 – Obligations fulfilled by undertaking a service

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.

Do you support the proposal in paragraph B8? If not, why not?

16. We do not support the proposal in paragraph B8. As we commented on Question 1, measurement of liabilities should be based on the estimated future outflow ultimately required to settle the obligations, in order to provide information useful for users of financial statements in predicting future cash flows. According to the measurement objective we suggested in Question 1, "the resources required to fulfil the obligation" in paragraph 36B (a) would be measured at the cost rather than the value and the entity's own margin is not included.

17. For an obligation fulfilled by undertaking a service, an entity has an option either to (a) outsource the service to a contractor or (b) undertake the service by itself. In case of outsourcing, the amount the third party contractor would charge is the cost (future outflow) expected to be borne by the entity and we consider it appropriate that the amount includes the contractor's margin. On the other hand, in case that the entity will undertake the service by itself, we believe that measurement

based on paragraph B8 would be inappropriate because the cost (future outflow) expected to be borne by the entity should not include the entity's own margin.

18. We suggest that the guidance should be changed so that the estimated outflow of resources should be always measured based on the cost borne by the entity, consistently with the measurement objective we suggested above. Although paragraph B8 (a) and (b) separate the cases by whether market exists or not, we do not consider such classification is appropriate since an entity may undertake the obligation by itself even when market exists. According to our suggestion, the expected costs in the case of outsourcing would be the amount the third party contractor would charge to undertake the service on the entity's behalf. And the expected cost in the case of the entity undertaking the service by itself would be the internal cost incurred to the entity, not including profit margin.

Question 3 – Exception for onerous sales and insurance contracts

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.

Do you support the exception? If not, what would you propose instead and why?

19. As we commented on Question 2, we believe that measurement of liabilities should always be based on the cost expected to be borne by the entity to fulfil its contractual obligations. Therefore, we agree with the measurement of onerous contracts proposed in the ED. However, according to our suggestion above, such measurement is same with our principle for measurement of liabilities within the scope of IAS 37 and it need not be treated as exceptions.

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We hope that our comments therein contribute to the forthcoming deliberations in the project.

Yours sincerely,

Ikuo Nishikawa
Chairman, Accounting Standards Board of Japan