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

Dear Sir David:

Exposure Draft
Proposed Amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*

Deloitte Touche Tohmatsu is pleased to comment on the International Accounting Standards Board's (the IASB's or Board's) proposed amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* (the ED).

With the exception of the proposals for restructuring provisions, we do not support the ED, which we see as largely unnecessary. In our view, the majority of the Board's proposals are premature and pre-judge matters that should be discussed in the context of the review of the IASB *Framework* rather than as an amendment of IAS 37. We think that IAS 37 is operating satisfactorily within the current accounting model and environment. In addition, we do not think that the Board's choice of a single measurement attribute is appropriate. As such, we find the majority of the changes proposed in the ED fail to achieve an improvement in financial reporting for one or more of the following reasons:

- The proposals will not provide sufficiently reliable and relevant information to users of financial statements.
- The proposals and their rationale are confused and/ or confusing. In particular, the proposals separate recognition and measurement for what are currently known as contingent liabilities and these are not readily separable in practice.
- In their current form, the proposals cannot be implemented in such a way that the necessary high degree of consistent application can be achieved.

Our criterion in assessing the proposals is whether the accounting information provided about an entity's non-financial liabilities and the uncertainty relating to the future outflows of economic benefits that will be required to settle them will be improved when compared to the information provided currently. We think that the proposals do not satisfy this criterion.

In particular, we are concerned that the proposals with respect to the measurement of discrete non-contractual obligations, such as a lawsuit against an entity, will result in information that is misleading. We do not think that financial reporting will be improved by recognising as a liability and an expense an amount that is highly unlikely to be paid. We think that the *status quo* provides better information than the method proposed in the ED.

Furthermore, we do not think that the proposals have been explained in such a way as to make them capable of consistent and reliable implementation.

In short, we are not convinced that current practice is sufficiently flawed to warrant changing the fundamental approach in the current IAS 37 and we do not think that the Board's proposals will improve financial reporting generally. Hence, we do not support the majority of the Board's proposals. However, we do support the Board tightening the requirements for the recognition of restructuring provisions.

We have provided answers to the questions raised in the Invitation to Comment; these are in the attached Appendix to this letter.

If you have any questions concerning our comments, we would be pleased to discuss them.

Sincerely,

Ken Wild

Global IFRS Leader

Appendix

Question 1 – Scope of IAS 37 and terminology

Scope

We disagree with the Board's proposals. We think that Board's proposals are premature, given the Board's ongoing projects on insurance contracts and the IASB *Framework*. If the Board's intention is that IAS 37 becomes the 'residual' standard for non-financial liabilities, we think that these issues need to be resolved. If the Board does proceed with their proposals, they should clarify the scope with respect to the treatment of credits for deferred revenue and performance obligations.

Terminology

We do not support the change in terminology. We think that the advantages of the change are far outweighed by the loss of terms that work, are understood and accepted in practice.

Question 2 – Contingent liabilities

We disagree with the Board's proposals because:

- we do not think that they will provide more relevant and reliable information to users of financial statements;
- the proposals are expressed in a confused and confusing manner; and
- it is difficult to identify the underlying principles.

In our experience, it is in practice not possible to separate recognition from measurement for many non-financial liabilities. As such, we are of the view that the Board's intentions have not been articulated with sufficient clarity to overcome this difficulty and make the proposals operational.

With respect to the definition, we think that the Board should concentrate on improving the existing definition rather than inventing a new one. Preparers, users and auditors know that present obligations should be recognised in the financial statements, know how to identify them and are able to do so in all but a small minority of situations. Consequently, we think that the Board should concentrate on part (b) of the current definition of a contingent liability, that is, that part which refers to a present obligation for which the outflow of resources is not probable or for which a reliable measure is not possible.

We agree that items should be recognised as non-financial liabilities in financial statements only if they satisfy the definition of a liability in the IASB *Framework* and that the essential characteristic of a liability is that the entity has a present obligation arising from a past event (the proposed refinements to the defined terms make this clearer than it is in the current IAS 37). We agree that under the *Framework*, credits recognised in the balance sheet (other than equity) should only be liabilities, although we acknowledge that under the current mixed attribute model, certain balances (e.g., deferred income) that do not meet the definition of liabilities will be recognised on the balance sheet.

We have significant concerns with the recognition and measurement of such non-financial liabilities. These are discussed under Q5/ Q6, below.

Question 3 – Contingent assets

We disagree with the Board's proposals. We are not aware of sufficient diversity in practice to suggest that the current requirements in IAS 37 are not operational.

In addition, we do not think that the Basis for Conclusions for this change is sufficiently robust. In particular, basing its decision in part on tentative decisions in the Board's project on revenue recognition is inappropriate: not only have those decisions not been subjected to public comment, the Board itself has stated that it was 'finding it difficult to achieve consensus on some aspects of the conceptual model that had been developed in the project' (*IASB Update* June 2005).

Symptomatic of this rationalisation is the potential inconsistency between the Board's proposals for what are currently defined as contingent assets and reimbursement rights. We see a high degree of similarity between the two (they both arise from past events and the realisation is not within the control of the entity), and question why one class of asset is to be addressed in IAS 38 *Intangible Assets* and one in IAS 37, with very different recognition criteria.

Question 4 – Constructive obligations

We disagree with the Board's proposals. We are not aware of sufficient diversity in practice to suggest that the current requirements in IAS 37 are not operational.

Question 5/ Question 6 –Recognition and measurement

We have fundamental concerns with the Board's proposals because:

- we do not think it is possible to separate recognition and measurement for most of those liabilities currently known as contingent liabilities;
- the proposals are expressed in a confused and confusing manner; and
- it is difficult to identify the underlying principles.

In particular, we do not think that the Board's proposals are capable of being implemented and made operational with sufficient reliability and, as such, will be more open to manipulation and abuse than under the current IAS 37. Consequently, we do not think they will result in more reliable information being given to users of financial statements.

Recognition

We do not think that the Board's analysis of obligations into 'unconditional' and 'conditional' is helpful; indeed we think that the analysis is unnecessarily complicated and tends to confuse (rather than clarify) a concept generally well understood in practice. We think that whether an entity has an obligation is a question of fact.

While we think that the recognition point for non-financial liabilities is appropriate, it could be articulated in a much clearer manner: that at initial recognition, a non-financial liability is an unconditional obligation of uncertain amount. The Board could then give straightforward examples of such liabilities.

- For example, if the non-financial liability is a statutory liability (for example, that arising on the sale of goods or rendering of services under relevant legislation), a stand-ready obligation arises when the goods are sold or the services rendered.
- If the liability is a contractual liability (for example, those arising under warranties), a stand-ready obligation arises when the warranty is sold or issued.

- Finally, a stand-ready obligation arising as a result of legal liability is recognised when the event giving rise to the legal liability occurs, not when the entity becomes party to legal proceedings. In our view, the principle defined in the ED and the examples given do not make clear the recognition point in this regard, because they have not been defined in a sufficiently robust manner to provide a clear dividing line between liabilities and business risks.

Measurement

Many of the issues in this area of accounting are similar to those facing the Board in their Insurance Contracts project and might benefit from waiting for the Board's resolution of the issues in that project.

The root of our concern is the Board's proposal to require the use of the amount that the entity would rationally pay to settle the obligation or to transfer it to a third party on the balance sheet date (the 'expected value') for all non-financial liabilities. We agree that expected value is the most appropriate measure for many liabilities including non-financial liabilities for which the population is large and homogeneous (for example warranty obligations).

However, for many non-financial liabilities (especially those arising under legal liability), the law of large numbers does not apply and expected values will not be obtainable. We support the use of an expected cash flow model, however we think that the most appropriate one is that in the *Framework*, 'the present discounted value of the future net cash outflows that are expected to be required to settle the [liability] in the normal course of business' (Fw 100(d)). We think that this is appropriate because most, if not all such non-financial liabilities will be settled by the entity itself and will not be laid-off. We also question paragraph 40—we cannot think of any circumstance in which an entity-specific interest rate for such a liability could be lower than the risk-free rate.

Our concerns with requiring the use of expected values are most acute when considering discrete liabilities, such as significant lawsuits that the entity is defending and monitors on an ongoing basis. For such liabilities, we think that the amount that would be recognised under the proposals would fail both the relevance and reliability characteristics in the IASB *Framework*. To recognise and measure a 'stand-ready obligation' related to an item for which the entity will either pay zero (98% probability) or €100 million (2% probability) at an amount of €2 million is not relevant to users. Indeed, we think that booking such an amount would be misleading. The current requirement, with adequate disclosure of the potential effects on the entity, in our view, provides more relevant information to users as it gives them adequate information with which to estimate future cash flows.

We are concerned that by requiring all such liabilities to be measured, the manner in which something is reported in the financial statements will change the perception of that non-financial liability and ultimately its settlement amount. We do not believe that this is an appropriate result for an accounting standard. Accounting should reflect business economics not distort them.

Question 7 – Reimbursements

In addition to our comments on Question 3, above, we do not see that there is sufficient divergence in practice to require a change to IAS 37.

Question 8 – Onerous contracts

We agree that if a contract will become onerous as a result of the entity's own actions, the entity should not recognise the liability until it has taken the action. We take this to mean actions subsequent to entering into the contract (unless the contract is onerous at inception). However, we are concerned that slightly unequally unperformed executory contracts will always fall into this category. We would not support including such transactions within the scope of IAS 37 and urge the Board to state definitively that such transactions are outside the scope of the Standard.

Again, we are concerned that the Board is proposing amendments to IAS 37 in a situation in which we do not see a significant divergence in practice to warrant such a change.

Question 9 – Restructuring provisions

We agree with the proposals and note that they should result in a more faithful representation of the liabilities incurred in a restructuring. The accompanying guidance is appropriate.