Institute of Actuaries of Australia

28 October 2005

Mr Henry Rees
Project Manager
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
UNITED KINGDOM

By email: CommentLetters@iasb.org.uk

Dear Mr Rees,

SUBMISSION ON THE PROPOSED IMPROVEMENTS TO IAS37

The Institute of Actuaries of Australia (the IAAust) has a keen interest in the ongoing development of the International Financial Reporting Standards (IFRS) of the International Accounting Standards Board (IASB). In this regard, the IAAust has made submissions on a number of prior exposure drafts and discussion papers of the IASB and participates in the relevant committees of the International Actuarial Association (the IAA) providing input to various IASB projects. In particular, the IAAust has an interest and appreciates the opportunity to provide its views in areas such as:

- The Insurance Project which impacts on an industry with significant actuarial involvement.
- Proposals on Financial Instruments accounting which also impacts many industries and businesses in which actuaries are involved in management and public reporting.
- Accounting developments involving fair value or similar measurement bases where actuarial valuation and analysis techniques can be relevant to the standards being developed.

In this context, we have prepared the attached submission. This provides a number of comments on the proposed amendments to IAS37. This submission represents the views of the actuarial profession in Australia.

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We hope that our comments will be of assistance to the IASB and we would be pleased to clarify or discuss further any aspect of these submissions as appropriate. In the first instance, please contact Catherine Baldwin, our Chief Executive via email (catherine.baldwin@actuaries.asn.au) or ph: +61 2 9239 6106.

Yours sincerely

Andrew Gale
President

INSTITUTE OF ACTUARIES OF AUSTRALIA

SUBMISSION TO IASB ON ED PROPOSED AMENDMENTS TO IAS 37

1. Introduction

The purpose of this submission is to bring to the attention of the IASB the views of the Institute of Actuaries of Australia (IAAust) on a number of matters reflected in, or arising from, the Exposure Draft of Proposed Amendments to IAS37 (the ED).

Our submission strongly supports the general thrust of the proposed amendments.

We do, however, have a number of suggestions on how they could be improved.

This submission comprises:

- An outline of our views on the ED in their general application to financial institutions.
- Comments on the questions asked in the ED

We do not, at this stage, plan to comment on the proposed changes to IAS 19.

2. ED Comments and Observations in General

2.1 Measurement vs Recognition

The IAAust strongly supports what it sees as the general thrust of the proposed amendments. That is, that uncertainty should be regarded as a **measurement** issue and should not be a consideration in deciding whether or not an asset or liability should be **recognised**. As we have previously argued, a requirement focused on whether an outcome is **probable** (i.e. more likely than not) is an unsatisfactory basis for recognition. This is particularly the case in the context of insurance where the “work-around” of looking at groups of similar insurance policies, rather than individual policies, may not always work. In practice, sound existing insurance accounting standards regard measurement uncertainty as irrelevant to the recognition of insurance liabilities.

Once the existence of a liability obligation has been established, the only criterion for non-recognition that could be considered is materiality (with materiality considered collectively, as the sum of all liabilities, as well as individually).

2.2 Terminology

We consider that the term “non-financial liabilities” is confusing and does not have its natural meaning. In particular, most of the liabilities under consideration are, in fact, financial liabilities. We would prefer to see “uncertain liabilities”, “variable liabilities”, “general liabilities”, “other liabilities” or even, simply, “liabilities”. Alternatively, the old term, “provisions”, could be retained and used as the title of the standard.

2.3 Reliable Measurement

The standard still retains the binary condition "can be measured reliably". Reliability is a question of degree and should not be used as the basis for yes/no decisions. As otherwise reflected in the standard, anything that meets the definition of a liability should be recognised. Reliability should be a measurement and disclosure issue.

While the draft standard does suggests that reliable measurement will be possible in all but extremely rare cases, it does not give an indication of what such cases might be nor of the criteria for "reliable measurement". We would prefer to see this condition removed.

In the absence of a definition of "reliable", it is necessary to fall back on general usage and the definition in the *Framework*, which reads:

> *Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.*

In the absence of further qualification, it is difficult to escape the conclusion that highly uncertain estimates are unreliable and should not be recognised under the standard as worded. Again, the insurance context brings this into focus. The outcome of individual insurance policies is almost invariably highly uncertain. Even for a portfolio of similar policies, there is usually material uncertainty, in the sense that it potential users would likely make diametrically opposite decisions over the probable range of liability outcomes. The clear inference is that insurance liabilities should seldom be **recognised**.

A different approach to reliability is given in the AASB Statement of Accounting Concepts 3. The relevant section reads:

> *… if there is faithful representation of information, including the uncertainties surrounding it, it may be possible for it to be regarded as being reliable.*

In our view, based on our experience in making estimates in the context of uncertainty, this type of approach is more appropriate. That is, "faithful representation" in the form of an estimate with disclosure" should be regarded as providing "reliable" information.

If this approach is adopted, it makes much more sense to regard reliability, not as a criterion for recognition, but as a requirement for disclosure. If there is material uncertainty in an estimate of an item that is recognised then that uncertainty must be disclosed.

Because uncertainty is often not "additive", it is necessary to qualify this requirement. If the collective uncertainty for a group of items is not material, then the collective estimate should be regarded as "reliable". If an estimate is highly uncertain and this uncertainty cannot be adequately ameliorated by such measurement pooling, then the uncertainty in the estimate must be disclosed, or in cases where the uncertainty is difficult to quantify, the circumstances giving rise to the uncertainty must be disclosed.

It must also be accepted that there are circumstances where the range of uncertainty is material but the probability-weighted value is not (e.g. a single very low likelihood event). In such a case, it may be acceptable to recognise a zero value combined with appropriate disclosure of the uncertainty.

2.4 Definition of Liability

The definition of "liability" includes the phrase "is expected to result in". This does not sit well with the discussion and with the rest of the standard, and could be read to imply a "probable" test.

If, as we understand, the purpose of this phrase is to distinguish between assets and liabilities, it would be better to use:

> *A **liability** is a present obligation of the entity, arising from past events, the settlement of which would result in an expected net outflow from the entity of resources embodying economic benefits.*

or

> *A **liability** is a present obligation of the entity, arising from past events, which would, if settled, result in an outflow from the entity of resources embodying economic benefits.*

2.5 Onerous Contracts

The discussion of onerous contracts also seems to imply a binary choice - a contract either is or is not onerous. There is no discussion of contracts that may be onerous under some conditions, but not under others. This issue needs to be addressed.

There is a similar problem in IAS 32 and 39, where it is assumed that a financial instrument is either an asset or a liability. In fact, there are cases where a contract (or a financial instrument) has the potential to have a range of net values, spanning both positive and negative. The first example in paragraph 57 is a case in point, as are most futures contracts.

There are two basic approaches in such a situation. The contract may be valued as a whole and treated as onerous if the probability-weighted expected value, less an appropriate risk margin, is negative.

Alternatively, it may be split into two parts, with the probability-weighted favourable outcomes treated as an asset and the probability-weighted unfavourable outcomes treated as a liability, with appropriate risk-adjustment in each case.

If the contract cannot be split in this way, we consider that the net value approach is simpler and easier to explain.

2.6 Conditional Obligations

The discussion of un-conditional and conditional obligations in the standard is confusing. It appears to us that in reality within the discussion that there are no conditional obligations. If something is an obligation, it is unconditional. It is the **amount** of the obligation that is conditional. The discussion should refer to obligations of conditional and/or uncertain amount.

The analysis in BC29 is incomplete and, as a result, incorrect when it concludes that there is no obligation. While there is no specific law, there is a general obligation to comply with the law, as enacted (or interpreted in the courts) from time to time. This is an unconditional obligation. The question then becomes one of measurement and materiality. If, for example, there were no active proposal for such a law, only cursory examination would be needed to conclude that the value of its impact is not material and, therefore, should not be recognised. Somewhere along the path through the lobbying and legislative process, however, the law could become sufficiently likely that the value of its impact is material, in which case that value should, if this were the only consideration, be recognised.

However, there is a better argument that proposed legislation should not be anticipated in the body of the accounts. Just as accounts must be based on accounting standards in force at the balance date so, *a fortiori*, they must be based on the law as it stands at the balance date. This should not preclude discussion of the impact of likely future laws, but in the notes only.

Indeed, such disclosure should be mandatory if the impact of the change in law would be material.

This is not a question of either recognition or measurement, but of legal basis. If this is the underlying motivation for BC29, it should be re-drafted to make this point directly and to establish that the "current law" principle is not over-ridden by the existence of an unconditional obligation to obey future laws, if and when enacted.

2.7 Unavoidable Costs

The discussion of "unavoidable costs" in 58 focuses on only the legal position. There are many circumstances where an entity needs, for commercial reasons, to fulfil an onerous contract, even if it could escape the contract by paying a smaller penalty. It is arguable that the value should be based on the realistic value taking into account the impact of commercial considerations.

Likewise, the discussion of constructive obligations in BC54ff does not address the issue of whether the concept of constructive obligations should be extended to the competitive and other commercial constraints that can be characterised as commercial necessity.

2.8 Discounting

The discussion of discounting adopts a time value of money approach but leaves open the possibility that the discount rate may be inappropriately risk-adjusted to deal with some liability risks. Ideally, the concepts of risk and time-value should be separated with the discount rate focused primarily on the time value of money. In practice, however, many financial instruments are priced, in the market, in terms of a risk-adjusted discount rate. This is reasonable for liabilities where the risk can be directly calibrated to market transactions, but may result in inappropriate risk adjustments in other circumstances.

It is also preferable, in the interests of transparency, that any material risk adjustment should be disclosed as part of the disclosure of uncertainty.

2.9 Tax Impacts

We note that paragraph 34 indicates that the liability should be measured before tax. This is also reflected in paragraph 38 where the discount rate is specified as "pre-tax".

This is clearly appropriate where the provision for the liability is tax deductible.

However, where the actual liability is not tax deductible (e.g. a taxation fine) both the final payment and the unwind of the discount reflected in the provision will need to be met from the sacrifice of future after tax economic resources (or 1/[1-tax rate] times as much pre tax resources). In our view the total provision held in respect of such a liability, between IAS37 and IAS12, needs to sum to an amount equivalent to the liability discounted at the "after tax" discount rate. This may require a deferred tax liability to be held under IAS12 if the IAS37 provision is discounted pre-tax. It is not clear to us that this would be the outcome under the current standards, if such a provision is valued at a pre-tax discount rate under IAS37.

This has been an issue that has arisen under some national accounting standards in the past and is an issue under IAS19 in Australia at present, where the relevant standard and the taxation standard deal reasonably with the tax status of the immediate provision and final payment, but are blind to the tax treatment of the unwind of the discount rate in between, if this has to be met from after tax income.

We note that there are other combinations of tax treatments including non-deductibility of provisions but deductibility of final payments that would result in complex IAS12 tax treatments to give the correct total result but where the base standard requires a "gross" only assessment.

It is in our view highly desirable for this issue to be directly addressed in standards such as IAS37 and IAS19, as well as in IAS12.

2.10 Restatement

In paragraph 72, the restatement of earlier information is prohibited. Is this the intention or should restatement be allowed but not required?

2.11 Implications for the Insurance Project

We note that there are a number of implications for the insurance project, if the decisions taken here, are followed.

- A fair value like approach has been adopted, without undue emphasis on market prices.
- A prospective approach has been adopted, without regard to whether there is historic cost information available.
- Discounting is required.
- A risk margin is required.

We support this framework.

3. Responses to specific questions posed by IASB

Question 1 – Scope of IAS 37 and terminology

The Exposure Draft proposes to clarify that IAS 37, except in specified cases, should be applied in accounting for all non-financial liabilities that are not within the scope of other Standards (see paragraph 2). To emphasise this point, the Exposure Draft does not use 'provision' as a defined term to describe liabilities within its scope. Instead, it uses the term 'non-financial liability' (see paragraph 10). However, the Exposure Draft explains that an entity may describe some classes of non-financial liabilities as provisions in their financial statements (see paragraph 9).

(a) Do you agree that IAS 37 should be applied in accounting for all non-financial liabilities that are not within the scope of other Standards? If not, for which type of liabilities do you regard its requirements as inappropriate and why?

(b) Do you agree with not using 'provision' as a defined term? If not, why not?

(a) Yes, but we find the term "non-financial liabilities" confusing and lacking a natural interpretation. Possible alternatives include "uncertain liabilities", "variable liabilities", "general liabilities", "other liabilities" and/or "provisions".

(b) While we do not have a strong view, it may be useful to have a separate term, so that the distinction between a liability and the provision for that liability can be maintained.

Whatever the decision of the Board, it is unlikely that the term "provision" will vanish from general use.

Question 2 – Contingent liabilities

The Exposure Draft proposes to eliminate the term 'contingent liability'.

The Basis for Conclusions on the proposals in the Exposure Draft explains that liabilities arise only from unconditional (or non-contingent) obligations (see paragraph BC11). Hence, it highlights that something that is a liability (an unconditional obligation) cannot be contingent or conditional, and that an obligation that is contingent or conditional on the occurrence or non-occurrence of a future event does not by itself give rise to a liability (see paragraph BC30).

The Basis for Conclusions also explains that many items previously described as contingent liabilities satisfy the definition of a liability in the *Framework*. This is because the contingency does not relate to whether an unconditional obligation exists. Rather it relates to one or more uncertain future events that affect the amount that will be required to settle the unconditional obligation (see paragraph BC23).

The Basis for Conclusions highlights that many items previously described as contingent liabilities can be analysed into two obligations: an unconditional obligation and a conditional obligation. The unconditional obligation establishes the liability and the conditional obligation affects the amount that will be required to settle the liability (see paragraph BC24).

The Exposure Draft proposes that when the amount that will be required to settle a liability (unconditional obligation) is contingent (or conditional) on the occurrence or non-occurrence of one or more uncertain future events, the liability is recognised independently of the probability that the uncertain future event(s) will occur (or fail to occur). Uncertainty about the future event(s) is reflected in the measurement of the liability recognised (see paragraph 23).

(a) Do you agree with eliminating the term 'contingent liability'? If not, why not?

(b) Do you agree that when the amount that will be required to settle a liability (unconditional obligation) is contingent on the occurrence or non-occurrence of one or more uncertain future events, the liability should be recognised independently of the probability that the uncertain future event(s) will occur (or fail to occur)? If not, why not?

(a) Yes. We support, in general, the reasoning of the IASB.

(b) Yes. We support, in general, the reasoning of the IASB.

Question 3 – Contingent assets

The Exposure Draft proposes to eliminate the term ‘contingent asset’.

As with contingent liabilities, the Basis for Conclusions explains that assets arise only from unconditional (or non-contingent) rights (see paragraph BC11). Hence, an asset (an unconditional right) cannot be contingent or conditional, and a right that is contingent or conditional on the occurrence or non-occurrence of a future event does not by itself give rise to an asset (see paragraph BC17).

The Basis for Conclusions also explains that many items previously described as contingent assets satisfy the definition of an asset in the *Framework*. This is because the contingency does not relate to whether an unconditional right exists. Rather, it relates to one or more uncertain future events that affect the amount of the future economic benefits embodied in the asset (see paragraph BC17).

The Exposure Draft proposes that items previously described as contingent assets that satisfy the definition of an asset should be within the scope of IAS 38 *Intangible Assets* rather than IAS 37 (except for rights to reimbursement, which remain within the scope of IAS 37). This is because such items are non-monetary assets without physical substance and, subject to meeting the identifiability criterion in IAS 38, are intangible assets (see paragraph A22 in the Appendix). The Exposure Draft does not propose any amendments to the recognition requirements of IAS 38.

(a) Do you agree with eliminating the term ‘contingent asset’? If not, why not?

(b) Do you agree that items previously described as contingent assets that satisfy the definition of an asset should be within the scope of IAS 38? If not, why not?

(a) Yes. We support, in general, the reasoning of the IASB.

(b) Yes.

Question 4 – Constructive obligations

The Exposure Draft proposes amending the definition of a constructive obligation to emphasise that an entity has a constructive obligation only if its actions result in other parties having a valid expectation on which they can reasonably rely that the entity will perform (see paragraph 10). The Exposure Draft also provides additional guidance for determining whether an entity has incurred a constructive obligation (see paragraph 15).

(a) Do you agree with the proposed amendment to the definition of a constructive obligation? If not, why not? How would you define one and why?

(b) Is the additional guidance for determining whether an entity has incurred a constructive obligation appropriate and helpful? If not, why not? Is it sufficient? If not, what other guidance should be provided?

(a) Yes.

(b) Not entirely. It would be helpful to clarify that the indication required by paragraph 15(a) can be implicit, as well as explicit. For example, participation in a market is, unless otherwise indicated, implicit indication of an intention to follow the norms of that market.

Question 5 – Probability recognition criterion

The Exposure Draft proposes omitting the probability recognition criterion (currently in paragraph 14(b)) from the Standard because, in all cases, an unconditional obligation satisfies the criterion. Therefore, items that satisfy the definition of a liability are recognised unless they cannot be measured reliably.

The Basis for Conclusions emphasises that the probability recognition criterion is used in the *Framework* to determine whether it is probable that settlement of an item that has previously been determined to be a liability will require an outflow of economic benefits from the entity. In other words, the *Framework* requires an entity to determine whether a liability exists before considering whether that liability should be recognised. The Basis notes that in many cases, although there may be uncertainty about the amount and timing of the resources that will be required to settle a liability, there is little or no uncertainty that settlement will require *some* outflow of resources. An example is an entity that has an obligation to decommission plant or to restore previously contaminated land. The Basis also outlines the Board's conclusion that in cases previously described as contingent liabilities in which the entity has an unconditional obligation and a conditional obligation, the probability recognition criterion should be applied to the unconditional obligation (ie the liability) rather than the conditional obligation.

So, for example, in the case of a product warranty, the question is not whether it is probable that the entity will be required to repair or replace the product. Rather, the question is whether the entity's *unconditional* obligation to provide warranty coverage for the duration of the warranty (ie to stand ready to honour warranty claims) will probably result in an outflow of economic benefits (see paragraphs BC37-BC41).

The Basis for Conclusions highlights that the *Framework* articulates the probability recognition criterion in terms of an outflow of economic benefits, not just direct cash flows. This includes the provision of services. An entity's unconditional obligation to stand ready to honour a conditional obligation if an uncertain future event occurs (or fails to occur) is a type of service obligation. Therefore, any liability that incorporates an unconditional obligation satisfies the probability recognition criterion. For example, the issuer of a product warranty has a certain (not just probable) outflow of economic benefits because it is providing a service for the duration of the contract, ie it is standing ready to honour warranty claims (see paragraphs BC42-BC47).

Do you agree with the analysis of the probability recognition criterion and, therefore, with the reasons for omitting it from the Standard? If not, how would you apply the probability recognition criterion to examples such as product warranties, written options and other unconditional obligations that incorporate conditional obligations?

Yes. We support, in general, the reasoning of the IASB. Nonetheless, we note our comments under 2.3 above that support removal of "unreliable measurement" as a potential overrider on recognition.

Question 6 – Measurement

The Exposure Draft proposes that an entity should measure a non-financial liability at the amount that it would rationally pay to settle the present obligation or to transfer it to a third party on the balance sheet date (see paragraph 29). The Exposure Draft explains 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. It highlights that measuring a single obligation at the most likely outcome would not necessarily be consistent with the Standard's measurement objective (see paragraph 31).

Do you agree with the proposed amendments to the measurement requirements? If not, why not? What measurement would you propose and why?

Yes, we agree with the approach. We note that paragraphs 35 to 37 make it clear that a risk adjustment is included.

Question 7 – Reimbursements

The Exposure Draft proposes that when an entity has a right to reimbursement for some or all of the economic benefits that will be required to settle a non-financial liability, it recognises the reimbursement right as an asset if the reimbursement right can be measured reliably (see paragraph 46).

Do you agree with the proposed amendment to the recognition requirements for reimbursements? If not, why not? What recognition requirements would you propose and why?

Yes, but the recognition should not be contingent on reliable measurement. As discussed above, if there is material measurement uncertainty, the appropriate response is to recognise the estimated value and then disclose the uncertainty, rather than to not recognise the value. It should also be noted that the net amount, after reimbursement, may be less uncertain than either the gross liability or the reimbursement. While both must be disclosed separately, it is essential that they be estimated consistently and that the net amount be a faithful representation of the net position, including a faithful representation of the net uncertainty. Because uncertainties are often not additive, a faithful representation of any material net uncertainty may require careful explanation.

Question 8 – Onerous contracts

The Exposure Draft proposes that if a contract will become onerous as a result of an entity's own action, the liability should not be recognised until the entity takes that action. Hence, in the case of a property held under an operating lease that becomes onerous as a result of the entity's actions (for example, as a result of a restructuring) the liability is recognised when the entity ceases to use the property (see paragraphs 55 and 57). In addition, the Exposure Draft proposes that, if the onerous contract is an operating lease, the unavoidable cost of the contract is the remaining lease commitment reduced by the estimated sublease rentals that the entity could reasonably obtain, regardless of whether the entity intends to enter into a sublease (see paragraph 58).

(a) Do you agree with the proposed amendment that a liability for a contract that becomes onerous as a result of the entity's own actions should be recognised only when the entity has taken that action? If not, when should it be recognised and why?

(b) Do you agree with the additional guidance for clarifying the measurement of a liability for an onerous operating lease? If not, why not? How would you measure the liability?

(c) If you do not agree, would you be prepared to accept the amendments to achieve convergence?

(a) Yes. However, we note that there may also be a range of possible outcomes, each with an associated probability. If these probabilities might change as a result of a voluntary action of the entity, the change should only be reflected when and if the action is taken, but account should be taken, in assessing the original probabilities, of any actions that the entity may be constrained to take.

(b) The guidance appears to focus only on contractual obligations. We would suggest that constructive obligations and indirect penalties should also be considered.

We believe that onerous constructive obligations should also be recognised.

In the case indirect penalties, an example is that walking away from a supply contract may cost more, in terms of damage to the entity's reputation as a reliable supplier, than the difference between the cost of fulfilling the contract and any direct penalty for walking away. It is arguable that commercial necessity should be considered in determining whether the contract is onerous and, if so, its value.

(c) Yes.

Question 9 – Restructuring provisions

The Exposure Draft proposes that non-financial liabilities for costs associated with a restructuring should be recognised on the same basis as if they arose independently of a restructuring, namely when the entity has a liability for those costs (see paragraphs 61 and 62). The Exposure Draft proposes guidance (or provides cross-references to other Standards) for applying this principle to two types of costs that are often associated with a restructuring: termination benefits and contract termination costs (see paragraphs 63 and 64).

(a) Do you agree that a liability for each cost associated with a restructuring should be recognised when the entity has a liability for that cost, in contrast to the current approach of recognising at a specified point a single liability for all of the costs associated with the restructuring? If not, why not?

(b) Is the guidance for applying the Standard's principles to costs associated with a restructuring appropriate? If not, why not? Is it sufficient? If not, what other guidance should be added?

We do not comment on this question.

We hope that our comments will be of assistance to the IASB and we would be pleased to clarify or discuss further any aspect of these submissions as appropriate. In the first instance, please contact Catherine Baldwin, our Chief Executive via email (catherine.baldwin@actuaries.asn.au) or ph: +61 2 9239 6106.