The Chairman
Australian Accounting Standards Board
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Law Council
OF AUSTRALIA
International Law Section

Dear Sir

ED 140 – Proposed Amendments to AASB 137 – Provisions, Contingent Liabilities and Contingent Assets

This submission is made on behalf of the Corporations Committee of the Business Law Section of the Law Council of Australia ("the Committee").

Please note that this submission has been endorsed by the Executive of the Business Law Section. However, owing to time constraint, the submission has not been considered by the Council of the Law Council of Australia.

The Committee wishes to express concerns about what it understands to be the consequences of one of the proposals set out in ED 140 in relation to recognition and valuation of liabilities. Although the Committee does not pretend to be expert in matters of accounting, the Committee nonetheless considers it is appropriate to make comment on this proposal due to the serious and presumably unforeseen consequences that may be imposed by the proposed change. The Committee wishes to ensure the AASB is aware of these consequences and the serious nature of the concerns that they raise for corporations in Australia that are subject to public reporting requirements.

The proposal of concern is the removal of the concept of contingent liabilities, and the valuation of liabilities that would generally have been treated as contingent (such as liabilities associated with legal actions) on the basis of (a) the amount an entity would rationally pay to settle the obligation, or (b) the amount the entity would rationally pay to transfer it to a third party.

This may mean, where a corporation is the defendant in a legal action before a court, that the corporation would need to disclose the amount it would be (rationally) prepared to pay to settle the claim. This presumably requires a corporate defendant to disclose of the amount it is in fact prepared to pay to settle the matter (assuming it acts rationally).

The change to accepted litigation practice and adverse tactical implications of this ought to be obvious. The significant prejudice that could be imposed on a reporting corporation that was a defendant in a claim should be obvious, but we will state it anyway – a corporate defendant subject to public reporting requirements will be required disclose (in effect to its opponent) what it is prepared to pay to settled the matter. In our submission, this likely prejudice is not justified; we are not aware of any evidence to suggest that reporting of contingent liabilities in relation to claims against corporations has led to misleading financial results or misleading financial statements.

Indeed, we suspect that the removal of the contingent liability concept may, in fact, lead to less useful disclosures, since that a reporting entity will be required to choose between recognising a liability, and presumably reporting no liability, contingent or otherwise. If recognising a liability could be prejudicial, then there is an inbuilt incentive to disclose nothing, thus adversely affecting users of financial statements by reducing available information. The existing contingent liability concept at least provides a third alternative that encourages useful disclosure, rather than discouraging it.

Further, we speculate that the proposal, if implemented, will give a further tactical advantage to plaintiffs in litigation against corporate defendants, by allowing them to make tactical complaints to the corporate regulator about the valuation and disclosure of liabilities attributed to their litigation, with a view to gaining a collateral advantage.

In addition to the unsatisfactory consequences of ED 140, in our submission the analysis appears flawed (once again recognising our expertise is not in matters of accounting).

In the Committee's view there should be no difference in principle in relation to the assessment of a liability made by the mere issue of court proceedings. As a matter of law (in all relevant jurisdictions) the obligation to provide compensation comes into existence on the occurrence of the relevant facts, not the issue of proceedings. The court establishes the existence of facts and makes an order based on the relevant law. ED 140 is simply misguided in paragraph 26 where it suggests that the issue of proceedings crystallises a liability or makes it somehow "unconditional". The issue of proceedings is merely one step in a process, which only becomes final when the court makes an order as to compensation.

There is, in undertaking any law suit, uncertainty about outcome, and uncertainty about valuation in respect of outcome. In those circumstances it is simply not appropriate to oversimplify the analysis and ignore the probability analysis associated with outcome, and assume that some payment will be made; and that it is merely a question of valuation (and implicitly that some sort of mean expected value will be meaningful). This is too simplistic.

It may be that in any given law suit the expected outcome is "bimodal" – either of two outcomes (either plaintiff wins or defendant wins) is equally likely, and which of them is the ultimate outcome will only be determined by the resolution of disputed facts or disputed law. These are matters that can only be resolved by resolution of the law suit itself (meaning that it is simply not possible to make a meaningful estimate of the outcome until the outcome has

crystallised). In such circumstances, to focus only on valuation of a payment to be made by one party, is likely to provide less than meaningful information, by seeking to reduce a complex set of circumstances to a single number which will not be representative of either possible outcome.

The Committee also note (emphasising again that our expertise is not in the accounting field) that some of the difficulties in ED 140 are underlined by the expression of some of the language in relation to Question 5 – when asking "*how would you apply the probability recognition criterion to examples such as product warranties, written options and other unconditional obligations that incorporate conditional obligations?*" We are simply unsure what is meant by "*unconditional obligations that incorporate conditional obligations*".

In summary, the Committee opposes the proposed changes to recognition of contingent liabilities and valuation of liabilities on the basis that the consequences will be significantly adverse to corporate reporting entities, with no apparent benefits. Further, the proposal appears to be overly simplistic and lacking in analytical rigour. The Committee considers that the current approach to disclosure of contingent liabilities is adequate, and there is no evidence of any need for change.

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If you would like to discuss this submission, please contact the Chairman of the Committee, John Keeves on (08) 8239 7119.

Yours faithfully

Peter Webb
Secretary-General
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