Organismo Italiano di Contabilità – OIC
(The Italian Standards Setter)
Via Poli 29, 00187 Rome, Italy
Tel. 0039/06/6976681 fax 0039/06/69766830
e-mail: presidenza@fondazioneoic.it

International Accounting Standards Board
30 Cannon Street
London, EC4M 6XH
United Kingdom
commentletters@iasb.org

19th May 2010

Re: ***Exposure Draft Measurement of Liabilities in IAS 37***

Dear Sir/Madam

We are pleased to provide our comments on the IASB Exposure Draft *"Measurement of Liabilities in IAS 37" (limited re-exposure of proposed amendments to IAS 37)* ('the ED').
We are aware that IASB requires comments only on the measurement requirements. However we think that the measurement objectives and the recognition criteria are closely related; therefore we would comment on the entire Working Draft of IAS 37 published on the IASB's website on 19 February 2010 (hereinafter "WD").

The OIC's main comments can be summarized as follows:

1. We disagree with the removal of the "probability of outflows" recognition criterion because: (i) this amendment should be considered in the context of the Framework project, (ii) the measurement of the contingent liabilities can be complex and difficult to apply in practice***;*** consequently, the information provided cannot be reliable or useful, (iii) this amendment creates a new difference between IFRSs and US GAAP, because paragraph 8 of FAS 5 requires an entity to recognise a contingency if it is probable that a liability has been incurred;
2. We do not think that "the expected present value technique" may, in any case, provide useful information to the users of financial statements;
3. It is not clear what the risk adjustment is intended to represent, the ED lacks guidance on how it should be calculated, it is not clear why the risk adjustment should be used, and consequently it can cause significant diversity in practice;
4. We disagree with the inclusion of a profit margin in the measurement of a "service obligation", because if an entity performs the service itself, it does not pay the profit margin and, paradoxically, the entity shall recognise an hipotetical profit when it fulfils its obligation.

It should be noted that the inclusion of a profit margin causes an immediate additional charge to profit and loss with a corresponding gain (the release of the additional charge) recognised later when the obligation is settled. In substance there is no out/inflow.

<u>Comments not required by the IASB:</u>

Regarding the scope of the WD we think that a clarification is necessary to understand whether warranties are within the scope of the new IAS 37 or not; since the scope exception of paragraph 3 (f) of the WD: "*liabilities arising from the application of the revenue recognition criteria in IAS 18 Revenue*", in our opinion, is ambiguous and could be misunderstood.

Regarding the recognition requirements of the WD we disagree with the removal of the "probability of outflows" recognition criterion for the above mentioned reasons.
We carefully read the IASB Staff Paper "Recognising liabilities arising from lawsuits" dated 7 April 2010 and we understand that:

- this amendment intends to shift the focus from the "probability of outflows" criterion to judging whether the entity has an obligation;
- in many cases the change in focus would not affect the recognition decision (if a present obligation exists then an outflow of resources should be probable)

We agree that an entity shall not recognise a liability if an outflow of resources is probable but a present obligation does not exist**,** although such a situation in our opinion will be rare. However we believe that, also for practical reasons, the probability of outflows recognition criterion should be used, especially when there are uncertainties about the existence of an obligation since we think that the guidance provided in paragraphs 13 - 16 of the WD could generate diversity in practice. Indeed the outreach that we carried out with some preparers showed us that the proposed recognition criteria are more complex than the existing ones and therefore could cause errors in the financial statements. Consequently some preparers believe that they will spend a lot of time in judging if an obligation exists and in measuring contingent liabilities.

<u>Comments required by the IASB:</u>

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 proposals.
Do you support the requirements proposed in paragraphs 36A–36F? If not, with which paragraphs do you disagree, and why?

Paragraph 36A requires that an entity measure a liability at the amount that it would rationally pay at the end of the reporting period to be relieved of the present obligation.
We do not support the measurement requirement to base measurement on expected values, because the "*amount the entity would rationally pay at the end of the reporting period to be relieved of the obligation*" imply an exit value methodology. In addition, according to some preparers the costs outweigh the benefits, for the following reasons: (i) entities must obtain more information than in the past, (ii) the estimation of the amount, probability and timing of each possible outcome can be onerous and time consuming, (iii) entities are also required to assign

values and probabilities to unlikely scenarios and therefore the benefits can be limited by the unreliability of the results obtained.

The proposed standard requires an entity to measure a liability at the amount it would rationally pay to be relieved of an obligation, being the lowest of:
(a) the present value of the resources required to fulfil the obligation,
(b) the amount that the entity would have to pay to cancel the obligation; and
(c) the amount that the entity would have to pay to transfer the obligation to a
third party

If the information to determine the 3 amounts is available, the OIC is concerned with the practicality of applying a measurement criterion based on three different elements. Such an approach would required the entity to make three calculations to determine the lowest amount.
The outreach showed us that the objective of providing useful information to the users of financial statements can be achieved by improving the disclosures requirements, because the "expected value technique" can imply a too high degree of judgment. We suggest to measure a liability at the most likely outcome and to provide, in the notes, additional information regarding the other scenarios (amounts, probability, timing, etc…). As a consequence the users will know: the most likely outcome, the maximum risk, the probability of each possible scenario and so on.

We think that especially in some circumstances entities should measure liabilities at the most likely outcome. For example: assuming that an entity estimates there is a 90% probability to pay 1.000 CU and a 10% probability to pay 1.000.000 CU. According to expected value technique the entity recognises a liability amounting to 100.900 CU (the entity will never pay this amount). In our opinion an entity provides useful information if it recognizes a liabilities of 1.000 CU (the most probable future cash outflow) and in the notes states that the maximum risk is 1.000.000 CU with a 10% probability.
We are aware that the IASB does not intend to revisit this aspect, however we believe that, at least in some circumstances, the most likely outcome measurement criterion should be permitted.
Finally, in order to anticipate diversity in practice, we suggest to clarify the circumstances in which a risk adjustment should be included in the measurement of a liability and how such a risk adjustment should be determined.

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.
Paragraphs BC19–BC22 of the Basis for Conclusions explain the Board's rationale for this proposal.
Do you support the proposal in paragraph B8? If not, why not?

Paragraph B8 proposes that an entity should measure a liability to undertake a service by reference to the amount it would rationally pay a contractor to perform the service on its behalf.
The requirement to refer to the price the entity would pay to the contractor, implies the usage of an exit price methodology with the resulting inclusion of an hypothetical profit margin. We do not share such an approach, as it does not represent an actual amount of outflow of resources.

In addition, OIC believes that it is extremely rare that a market exists for most types of service. Consequently, paragraph B8 (b)of Appendix B, requires that in the absence of a market an entity has to estimate the amount it would charge another party at the future date to undertake the service. As said above, such an estimate would include the future costs plus an hypothetical margin. This margin is difficult to determine as the rendering of the related service is outside the entity's core business.

Consequently, we do not support the requirements proposed in paragraph B8, while we agree with the Alternative View, paragraph AV2 of the ED. Furthermore, the outreach with the preparers showed us that there is not an effective market for several types of service. The impact of this proposed amendment on entities financial position, in some cases, could be significant.

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.

Paragraphs BC23–BC27 of the Basis for Conclusions explain the reason for this exception.

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

The OIC shares the approach indicated in Appendix B of Paragraph B9 to avoid changes in present practice that might be reversed when the IASB replace the standards on revenue recognition (IAS 18) and insurance contracts (IFRS 4).

However, this exception should be a permanent solution and not a temporary one, and it should not be limited to onerous contracts, but applicable also to other liabilities.

If you have any queries concerning our comments, please do not hesitate to contact us.

Yours faithfully,
Angelo Casò
(Chairman)