The Corporate Reporting Users' Forum

To: Joan Brown
By email: jbrown@iasb.org

9th April 2010

Dear Ms Brown

We welcome the opportunity to respond to the recent re-exposure of IAS 37. Detailed responses to the questions raised are outlined below. In summary, CRUF members are broadly supportive of the proposed changes. The majority agree that the expected value methodology provides a more robust framework and greater transparency around the measurement of IAS 37 liabilities than the previous best estimate method. At the same time, CRUF participants are broadly unsupportive of certain aspects of the standard, namely the inclusion of a risk margin and profit margin within the expected value methodology.

CRUF participants would note however that obligations falling under the scope of IAS 37 are inherently uncertain in nature. In many instances, the "best estimate" approach may provide an equally meaningful measurement, with little additional cost to preparers. Furthermore, in the majority of instances the revised framework will fail to support a valuation in the balance sheet that is 100% accurate and so CRUF participants would therefore urge the IASB to place greater emphasis on improving disclosure in this area. For disclosure purposes, we would encourage the IASB to consider using both methods.

We recognize that this point regarding disclosure has been addressed in the recent Liabilities Working Draft. However CRUF participants remain concerned that disclosure in this area is likely to remain inadequate. In the first instance, current guidance fails to require disclosure of the basis under which the liability has actually been measured. Users will therefore undoubtedly struggle to understand how this value has been derived. This point is particularly relevant given the move away from a single measurement objective based purely on expected cash flow. Secondly, there is no requirement for disclosure of the range of potential outcomes around this value. Alongside management commentary on the associated risks, such analysis is vital for users to make their own assessment of the potential impact of the liability on cash flows. Finally, CRUF participants would like management to be provided with the flexibility to disclose information on alternative measurement basis where these could be useful to users (e.g. best estimate for liabilities underpinned by a limited range of expected outcomes).

CRUF members would also question whether the inclusion of a risk margin will provide information that is reliable or useful to users. While conceptually sound, the application of a risk margin reintroduces the concept of "prudence" to financial statements. Furthermore, it brings an additional layer of complexity to an exercise that is already highly subjective in nature. CRUF members are concerned that this will ultimately reduce the reliability and comparability of financial statements. In addition, we view the lack of guidance on the corresponding discount rate to be used in calculating the expected value as a flaw in the revised exposure draft, although we note that this has now been addressed in the recently released working draft.

In general CRUF members do not support the inclusion of a profit margin within the expected value measurement/approach. Unlike in instances where obligations are written under insurance contracts, margins arising under IAS 37 liabilities tell us little about the future cash flows or underlying profitability of the business. In fact, we believe, a profit margin will only actually incentivize corporations to do the wrong thing and repeat past mistakes.

As a final point, a number of CRUF members have raised concerns around the timing of this re-exposure. Five years have passed since the original exposure draft was released. To re-expose it now after such a long period and so shortly before the deadline for conversion into a full standard sets a dangerous precedent.

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?

- Generally CRUF members are supportive of the requirements proposed in 36A – 36F. The majority agree that the expected value methodology provides a more robust framework and greater transparency around the measurement of IAS 37 liabilities than the previous best estimate method. Furthermore we agree that the proposals overcome many of the ambiguities associated with the original proposals.
- We would note, however, that the "amount the entity would rationally pay at the end of the reporting period to be relieved of the obligation" points to a measurement objective underpinned by an exit value methodology. CRUF participants believe that information on exit values can be useful to users. This is particularly the case for subjective areas such as IAS 37 liabilities. However we would re-iterate our concerns over the ongoing movement within accounting standards towards a market valuation objective. CRUF members would like to see the IASB place greater emphasis on valuation methodologies underpinned by cash flows under existing business models. These members do not believe that it is the role of financial statements to emphasize managements' views regarding market values for the entity. Furthermore attempts to do so with reference to markets that

may not actually exist in practice will ultimately result in information that is misleading to users.

- Having said that, CRUF members are therefore supportive of the hierarchy within the measurement objective outlined in paragraph 36B. This leads to a pure exit value being applied only in instances when it is in shareholders' best interests for the company to adopt this strategy. Furthermore we recognize that the proposed hierarchy overcomes one of the primary issues associated with the original Exposure Draft, namely the need for greater definition around the terminology associated with the company's ability to extinguish the obligation (e.g. "fulfill" versus "cancel" versus "transfer").
- Appendix B outlines the proposed methodology for measuring the expected value in instances where the entity will fulfill the obligation itself. This value is underpinned by a probability weighted average of expected cash flows or flows of resources. CRUF participants agreed that in many instances the information produced under such a methodology would be useful to users and would provide greater transparency around the valuation of the liability than the original "best estimate" approach. However members also raised concerns that the approach could be overly mechanical and burdensome to preparers. This would be the case where obligations are underpinned by a limited range of outcomes such as, for example, where the outcome is binary or where there is a 95% probability assigned. In such instances "best estimate" would likely produce an equally meaningful result without any additional cost to preparers. However, such flexibility to preparers is not available under the revised proposals.
- In many instances the distribution of expected flows and the flows themselves will be highly uncertain. Forecasting these and allocating an expected probability will therefore be a subjective exercise. While such an exercise will undoubtedly improve transparency it is never likely to produce a valuation in the balance sheet that is 100% accurate. CRUF participants therefore believe greater emphasis should be placed on the disclosure framework around the reported liability. This framework should provide insight into the range of potential values around the reported liability and management commentary on the likelihood of alternative outcomes.
- The proposal introduces an explicit risk margin to the expected value measurement. The aim is to measure the underlying riskiness of the expected outcome. CRUF participants are keen to understand management's confidence around the forecast of future obligations. However, while agreeing that this approach is conceptually sound, the application of a risk margin reintroduces the concept of "prudence" to financial statements. Furthermore it brings an additional layer of complexity to an exercise that is already highly subjective in nature. In practice we feel that this is unlikely to lead to a more reliable and meaningful outcomes.
- At the same time, no guidance is given on what discount rate should be used to measure the liabilities. The fact that this has been left open to interpretation is a major flaw in the re-exposure.

Question 2 –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 fulfill such obligations. It proposes that the relevant outflows are the amounts that the entity should 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 or not?

- By including an explicit risk margin and profit element in the liability measurement, the IASB appears to be attempting to align IAS 37 with current thinking on the measurement of insurance liabilities. As outlined above, CRUF members are comfortable with the conceptual argument supporting the inclusion of a risk margin within the measurement objective. However, in general members are less comfortable with the theoretical support behind the inclusion of a profit element.
- The business model of an insurance company is to generate a profit through fulfilling the obligations written under insurance contracts. The physical flow of cash (premium), the resultant obligation and the eventual profit or loss made from unwinding this are all driven by a contract between the entity and its customer. Information contained in the risk and residual profit margin is highly relevant to user in providing an insight into the pricing and profitability of these contracts. In contrast it is unlikely that the obligations falling under the scope of IAS 37 will be underpinned by an underlying customer contract. The physical flow of cash is restricted to resources required to fulfill the obligation. Any profit margin included will be hypothetical in nature and not supported by a physical flow of cash. While possibly improving comparability between companies in rare instances where there is an identical obligation, inclusion of this profit margin is unlikely to provide any additional useful information to users.
- In line with the point made previously, the inclusion of this margin lends itself to a methodology seeking to value the liability against some (possibly hypothetical) external market. In the first instance CRUF participants would prefer the liability to measure the future obligation of the business in line with economic reality – i.e. the actual cost to the business of fulfilling the obligation. If shareholders can be better served by the company paying a contractor a fee (including margin) to fulfill its obligations, and such a transaction is identifiable, then it would be appropriate to follow the hierarchy identified in 36B.
- CRUF participants are also concerned that inclusion of this margin could provide an incentive to management to front load provisions in years when results are strong with a view to unwinding the overstated liability through the P&L at a later date.

Question 3 – 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 fulfill its contractual obligations, rather than the amounts the entity would pay a contractor to fulfill 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?

- We are supportive of these exceptions. However, as outlined above our preference would be for the relevant future outflows for all onerous contracts to be in the first instance costs the entity would expect to incur rather than the cost of paying some (potentially hypothetical) third party to fulfill the obligation on the company's behalf.

About the Corporate Reporting Users' Forum (CRUF)

The CRUF came together in 2005 as a discussion forum to help its participants in their approach to the debate on current and future corporate reporting requirements. In particular, participants are keen to have a fuller input into the deliberations of accounting standard setters such as the IASB and FASB.

CRUF participants come from all around the world, including individuals from both buy- and sell-side institutions, and from both equity and fixed income markets.

The CRUF is a discussion forum. Different individuals take leadership in discussions on different topics and in the initial drafting of representations. It does not seek to achieve consensus views, though at times some or all of its participants will agree to make joint representations to standard setters or to the media. It would not be correct to assume that those individuals who do not participate in a given initiative disagree with that initiative.

We sign this letter in our individual capacity as participants of the Corporate Reporting Users' Forum (www.CRUF.com) and not as representatives of our respective organizations. The views expressed are those of individual CRUF participants and do not necessarily reflect the views of the respective organizations where we are employed.

The participants in the Forum that have specifically endorsed this response are listed below.

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