CFA INSTITUTE | Centre for Financial Market Integrity

6 November 2006

Sir David Tweedie
Chair, International Accounting Standards Board
30 Cannon Street
London EC4M 6Xh
United Kingdom

Re: Amendments to IAS 37, Provisions, Contingent Liabilities and Contingent Assets

Dear Sir David:

The CFA Centre for Financial Market Integrity (CFA Centre) of CFA Institute,[1] in consultation with its Corporate Disclosure Policy Council (CDPC)[2], appreciates the opportunity to comment on the International Accounting Standards Board's ("IASB") proposal to amend International Accounting Standard 37, *Provisions, Contingent Liabilities and Contingent Assets.* The CFA Centre develops, promulgates, and maintains the highest ethical standards for the investment community including the CFA Institute *Code of Ethics* and *Standards of Professional Conduct*. The CFA Centre represents the views of investment professionals to standard setters, regulatory authorities, and legislative bodies worldwide to promote investor protection and efficient global capital markets.

General Comments

We strongly support the Board's proposal to amend IAS 37 to require the recognition of obligations in the financial statements when the definition of a liability in the IASB's Framework has been satisfied. This proposal seems axiomatic, even though current accounting literature, both in IAS 37 and U.S. Statement of Financial Accounting Standard No. 5 - *Accounting for*

[1] The CFA Centre for Financial Market Integrity is part of CFA Institute®. With headquarters in Charlottesville, VA and regional offices in New York, Hong Kong and London, CFA Institute, formerly the Association for Investment Management and Research®, is a global, non-profit professional association of more than 88,000 financial analysts, portfolio managers, and other investment professionals located in 130 countries of which more than 74,600 are holders of the Chartered Financial Analyst® (CFA®) designation. CFA Institute has 134 affiliated Member Societies and Chapters in 55 countries and territories.

[2] The objective of the CDPC is to foster the integrity of financial markets through its efforts to address issues affecting the quality of financial reporting and disclosure worldwide. The Council comprises individuals, who are investment professionals with extensive expertise and experience in the global capital markets, as well as CFA Institute member volunteers. In this capacity, the Council provides the practitioners' perspective in the promotion of high-quality financial reporting and disclosures which meet the needs of investors.

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Contingencies, permit the delayed recognition of liabilities. Therefore, we believe that this proposed change is long over due.

We concur with the Board's conclusion that this amendment to IAS 37 will enhance financial reporting. Investors and other users of financial reports will have a more representative picture of the company's financial position because obligations will be recognized rather than off the balance sheet in the note disclosures. Too often, "real" obligations, representing significant future commitment of a company's economic resources, are buried in note disclosures. As noted in the Centre's draft paper – *A Comprehensive Business Reporting Model: Financial Reporting for Investors:*

> ***4. Principle: All economic transactions and events should be completely and accurately recognized as they occur in the financial statements.***
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> ***Reasons for Importance:*** *The purpose of financial reporting is to convey the economic position of the company and changes in that position to investors. Reporting methods that omit or fail to reflect the economic essence of events and transactions as they occur do not achieve the purpose of financial reporting.*

In other words, disclosure of contingencies, which meet the definition of liabilities or assets, is not a substitute for recognizing the initial expected values, and requiring subsequent remeasurements, of these items in the financial statements.

Uncertainty as an Element of Measurement

We believe that it is appropriate to eliminate the current recognition criterion, which is based upon the level of probability, to recognize the obligation when it is incurred. The following proposed principles, under the Measurement section of the amendments to IAS 37, capture appropriately this change and are consistent with a fair value approach:

> ***Amount that an entity would rationally pay to settle or transfer the obligation; Paragraph 29*** *- An entity shall 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.*
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> ***Risks and uncertainties; Paragraph 35*** *– In measuring a non-financial liability in accordance with paragraph 29, an entity shall include the effects of risks and uncertainties.*

> ***Present value; Paragraph 38*** *– When an entity measures a non-financial liability using an estimation method that involves projections of future cash flows, it shall discount the cash flows using a pre-tax rate (or rates) that reflect(s) current market assessments of the time value of money and the risks specific to the liability. The discount rate(s) shall not reflect risks for which future cash flow estimates have been adjusted.*
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> ***Future events; Paragraph 41*** *– When measuring a non-financial liability, an entity shall reflect the effects of future events that may affect the amount that will be required to settle the obligation.*
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> ***Subsequent measurement; Paragraph 43*** *- An entity shall review the carrying amount of a non-financial liability at each balance sheet date and adjust it to reflect the current amount that the entity would rationally pay to settle the present obligation or to transfer it to a third party on that date.*

Measurement Based on Expected Value

We believe that the measurement of contingencies should be based on expected values. To this end, Statement of Financial Accounting Concepts No. 7 – *Using Cash Flow Information and Present Value in Accounting Measurements* ("Statement 7") provides a sound starting point for fair value estimation in the absence of observable market prices for identical or similar assets and liabilities. Although the technique is referred to in current accounting literature, it has not been widely applied in the past for many assets and liabilities, particularly those for which market inputs may not be readily available. If market inputs are not available, the measurement approaches in Statement 7 provide for significant entity input. As such, these inputs are more subjective by nature, and may not achieve key financial reporting objectives for consistency and comparability.

While we believe that Statement 7 should be incorporated into the fair value framework, we believe further guidance is needed for when entity specific data is used. The approach we prefer, which is the recommended approach in Statement 7, is that each expected cash flow should be risk adjusted and probability weighted, and then discounted based on an appropriate risk-free rate. If another approach is used[3], we recommend that guidance should be provided on the selection and use of the risk free rate, the spread to the risk free rate, and the risk premium under the methods outlined in Statement 7. For example, currently several risk free rates are used, such as LIBOR and various U.S. Treasury rates. Greater specificity in this regard would be helpful.

[3] Other methods are acceptable, often probability distributions for possible out comes are not available. For many projects, cashflows are estimated without direct consideration of the "risk" or volatility with the "risk" incorporated instead into discount rate.

In addition, we believe that the rate should be disclosed to enhance the user's understanding of the valuation method.

Disclosures about Contingencies

The need for adequate disclosures is even more critical given the dominant characteristic (i.e., uncertainty) of contingencies. Most sophisticated users of financial information realize that measuring contingencies involves making assumptions in order to estimate the future cash flows required to settle to a given contingency. In other words, they expect the measurement of contingencies to change from one reporting period to the next until the cash flows and other facts are certain.

Not all contingencies are the same. Therefore, the aggregation of contingencies should be based on similar characteristics, such as the event or transaction that gave rise to the contingency. Meaningful grouping of contingencies provides users with predictive information to evaluate the potential effects on the company's financial condition and future financial performance. Along with the estimated amount by each group of contingencies, there needs to be more explanation about the nature and uncertainty surrounding the contingencies. Such explanation should include: 1) a reconciliation of the carrying amounts by each group; 2) key assumptions used by the company to determine the expected values; and 3) other qualitative information regarding the nature of the contingency, i.e., the event or transaction, and explanation of the uncertainties surrounding the contingency.

For contingencies that are especially large, the disclosure of the range of possible outcomes (maximum and minimum) would also be helpful when that is possible. That requirement should be included in the required disclosures under paragraphs 68 (c) and 69 (c).

Therefore, we support the Board's proposed disclosures outlined in the following paragraphs of the proposed amendments to IAS 37:

> ***67*** *For each class of recognised non-financial liability, an entity shall disclose the carrying amount of the liability at the period-end together with a description of the nature of the obligation.*
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> ***68*** *For any class of recognised non-financial liability with estimation uncertainty, an entity shall also disclose:*
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> *(a) a reconciliation of the carrying amounts at the beginning and end of the period showing:*
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> *(i) liabilities incurred;*
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> *(ii) liabilities derecognised;*

(iii) changes in the discounted amount resulting from the passage of time and the effect of any change in the discount rate; and

(iv) other adjustments to the amount of the liability (e.g., revisions in estimated cash flows that will be required to settle it).

(b) the expected timing of any resulting outflows of economic benefits.

(c) an indication of the uncertainties about the amount or timing of those outflows. If necessary to provide adequate information, an entity shall disclose the major assumptions made about future events, as described in paragraph 41.

(d) the amount of any right to reimbursement, stating the amount of any asset that has been recognised for that right.

69 *If a non-financial liability is not recognised because it cannot be measured reliably, an entity shall disclose that fact together with:*

(a) a description of the nature of the obligation;

(b) an explanation of why it cannot be measured reliably;

(c) an indication of the uncertainties relating to the amount or timing of any outflow of economic benefits; and

(d) the existence of any right to reimbursement.

70 *In determining which non-financial liabilities may be aggregated to form a class, an entity considers whether the nature of the items is sufficiently similar for a single statement about them to fulfil the requirements of paragraphs 67-69. Thus, it may be appropriate to treat as a single class of non-financial liabilities amounts relating to warranties of different products, but it would not be appropriate to treat as a single class amounts relating to normal warranties and amounts subject to legal proceedings.*

71 *In extremely rare cases, disclosure of some or all of the information required by paragraphs 68 and 69 can be expected to prejudice seriously the position of the entity in a dispute with other parties on the subject matter of the non-financial liability. In such cases, an entity need not disclose the information, but shall disclose the general nature of the dispute, together with the fact that, and reason why, the information has not been disclosed.*

Contingencies Related to Business Combinations

We believe contingencies, whether they arise during the normal course of business operations or result from business combinations, should be accounted for in a similar manner. In this regard, our general view for recognizing and measuring contingencies is consistent with our response[4] to the IASB's proposed amendments to IFRS 3, *Business Combinations* and the accounting for contingent consideration:

> *Contingent consideration is an important part of the total acquisition cost in many acquisitions. Such consideration represents a commitment by the managers of the acquirer to transfer a portion of the wealth belonging to the consolidated entity, and hence, to the shareowners of the entity, to third-party sellers of acquired [net] assets. We agree that the amount of the contingent consideration pledged to the sellers at the acquisition date should be* ***estimated at that date****. However, the full economic cost to the company and its investors of that commitment, that is the full cost of the acquired assets, won't be known until the contingency period has passed and related measurements have been completed.* ***Consequently, we believe that the contingent consideration should continued to be remeasured and adjusted until all such contingencies have been resolved.*** *To fail to recognize such remeasured costs will have the effect of understating the full cost of the acquired [net] assets in many acquisitions, and may cause investors to be misled in evaluating the effects of such merger activity on the operations of the company. Such remeasurement is consistent with full fair value recognition as compared to historic cost recognition and measurement.* [Emphasis added.]
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> *We are also concerned that if the Standard requires that the fair value of contingent consideration be estimated and recognized only for the first year then managers will have an even greater incentive than they now do to structure acquisitions using significant amounts of contingent consideration. Moreover, they would have an additional incentive to bias downward their estimates of the amounts to be paid in future periods. We believe that such a provision could significantly undermine the fair value objectives of this Standard and could greatly reduce the usefulness of the resulting financial reporting.*

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[4] Comment letter sent to Sir David Tweedie dated 26 November 2005 responding the IASB's proposed amendments to IFRS 3, Business Combinations.

Closing Remarks

The CFA Centre for Financial Market Integrity, together with its Corporate Disclosure Policy Council, appreciates the opportunity to provide comment to the IASB on its Exposure Draft – IAS 37 *Provisions, Contingent Liabilities and Contingent Assets.* If you or your staff have questions or seek further elaboration of our views, please contact Georgene B. Palacky, by phone at +1.434.951.5326 or by e-mail at georgene.palacky@cfainstitute.org.

Sincerely,

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