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

**International Accounting Standards Board Exposure Draft, *Measurement of Liabilities in IAS 37, (Limited Re-Exposure of Proposed Amendments to IAS 37)***

Dear Sir David,

The CFA Institute,<sup>1</sup> in consultation with its Corporate Disclosure Policy Council (CDPC)<sup>2</sup>, appreciates the opportunity to comment on the International Accounting Standards Board (IASB or the Board) Exposure Draft, *Measurement of Liabilities in IAS 37 (Limited Re-Exposure of Proposed Amendments to IAS 37)*, (the ED).

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<sup>1</sup> With offices in Charlottesville, VA, New York, Hong Kong, and London, CFA Institute is a global, not-for-profit professional association of more than 96,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 133 countries, of whom nearly 83,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 136 member societies in 57 countries and territories.

<sup>2</sup> 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 CDPC is comprised of investment professionals with extensive expertise and experience in the global capital markets, some of whom are also CFA Institute member volunteers. In this capacity, the CDPC provides the practitioners' perspective in the promotion of high-quality financial reporting and disclosures that meet the needs of investors.



## Summary of Comments

Set forth below is a summary of our main positions as described in more detail in the following sections of this letter and in response to the specific questions posed in the ED.

1. Initial Measurement – We believe that the ED as drafted is unclear with regard to the definitions and practical application of the initial measurement criteria. In particular, the definition of what it means to “cancel” or “transfer” a liability and the evidence that an entity would have to obtain to determine whether either of these would meet the “lower of” test. As it relates to the definition of the present value of resources required to fulfil an obligation, we believe greater clarity is needed regarding the definition of the calculation and the objective of the present value measurement being proposed. Present value computations differ depending upon their inputs. It is not clear from a review of the ED as to whether the present value fulfillment computation in the ED is meant to arrive at a “cost approach”, “entity specific value approach”, or a “third party exchange value”. Finally, while there is an appearance of “exit value” comparison through the application of the initial measurement approach, without definition of the objective of the present value of fulfillment measurement, it is not apparent that the comparison will attain this objective. Without a fulfillment value measure which represents a comparable “third party exchange value,” including profit margins, the fulfillment value will likely always be lowest and, hence, the measurement selected.
  
2. Fulfillment Using Present Value Approach – As it relates to the fulfillment approach we have the following observations and comments:
  - a. Expected Loss Technique – We are fully supportive of the expected value or expected loss technique as a means of measuring obligations or impairments when outcomes are uncertain because we believe such a technique considers the impact of events or losses over the entire life of a contract or obligation and has the potential to incorporate and recognize the impact of future events which were incorporated into the pricing of a contract or the estimation of loss. The incurred loss model, in contrast, can only recognize losses after they have occurred. Accordingly, we believe an expected loss model should produce liability measurements that better reflect the estimation of pricing assumptions in contracts and the range of possible outcomes related to non-contractual obligations.

However, we believe that the expected loss approach requires appropriate disclosures to produce meaningful information for investors, allowing them to appropriately value the securities of entities with such obligations. Accordingly, we are recommending the enhancements of the Working Draft’s proposed disclosure requirements.

- b. Risk Margins – We believe it is essential that risk margins be included in the measurement of fulfillment value. We are concerned by the ED’s lack of guidance on the definition and measurement of the risk margin, the omission of a requirement to disclose the risk margin and the multiple alternatives available to incorporate the risk margin into the present value calculation. We believe the lack of guidance regarding the definition, measurement and means of incorporating the risk adjustment is likely to



result in significant diversity in practice and could be used to inappropriately bias measurements using the expected value technique. The Board should provide an explicit definition of risk margin – with special emphasis placed on precisely what types of risks are to be captured by the risk margin– and greater guidance on how such risk margins should be measured along with a requirement for risk margins to be explicitly incorporated into the present value calculation. This additional guidance, along with disclosure of risk margins, will reduce the opportunity for inconsistent application.

We also have concerns regarding the method by which risk margins might be incorporated into the expected loss computation. We have historically supported an explicit approach to assumptions; that is, assumptions should stand on their own and not be blended into other assumptions. The ED allows risk margins to be incorporated into the expected outflows, the discount rate, or added to the final expected value computation. Providing choices regarding the alternative means of incorporating risk margins contributes to inconsistencies in application of risk margins, lack of transparency regarding the explicit inclusion of these judgments and a lack of comparability. We believe the standard should provide a uniform approach to the incorporation of risk margin and we prefer option (c) in Paragraph B16 (i.e. calculating the expected present value of the future outflows and adding a risk adjustment to the amount so calculated) as we believe this approach is most intuitive and transparent.

- c. Profit Margins – We support measuring liabilities based on future outflow of resources and using market-based prices (that inherently include profit margins) for measuring the cost of fulfilling the obligation. Further, we believe there should be a requirement to disclose the amount of this profit margin and how it was determined.
  - d. Discount Rate – We agree that the expected outflows should be discounted to their present value using rates that reflect the current assessments of the time value of money; and risks specific to the liability. We believe that the proposed standard should provide greater clarity on how the discount rate used in the measurement of the fulfillment obligation is derived. In particular, we believe that the proposed standard should better describe the relationship among the characteristics of the liability including the risk of uncertainty (risk margin and/or market risk premium), the obligors’ own credit risk and the risk free rate. Without explicit guidance on what the discount rate is intended to represent there is potential for the omission or double-counting of risks and a lack of comparability of discount rates across enterprises.
3. Subsequent Measurement – We support the proposal that all changes to the liability associated with the passage of time should be reflected as a borrowing cost. We believe it is important that a detailed disaggregated rollforward – as described in the “Disclosures” section of this letter – should be provided as details of the original estimate as well as the development of management’s expectation are important for users to understand to ascertain the reliability of management’s estimates and the effects of measurement uncertainty on performance measures.



4. Onerous Contracts – We believe that a comprehensive standard on the measurement of liabilities should not provide for exceptions. The proposed exception would result in the exclusion of profit margins for onerous contracts with customers (i.e. contracts where management performs its business activities and seeks a profit margin) but the inclusion of profit margins for obligations which are not directly related to revenue producing activities. This does not appear to be either consistent or commercially reasonable.
  
5. Disclosures – We recommend the inclusion of additional disclosures regarding the measurement criteria as these are an integral part of the process of communicating to users the nature of the liability and its measurement. Our recommendations are in the areas of:
  - disaggregation,
  - initial measurement,
  - expected loss assumptions,
  - risk margin,
  - profit margin,
  - discount rate, and
  - inclusion of a rollforward

These disclosures will effectively communicate to users changes in the nature of the liability and management’s assumptions over time.

6. Considerations in Revising Measurement Criteria – In considering the modifications proposed in the ED related to measurement, we believe it is important that the IASB recognize the linkage between recognition and measurement and consider changes which may be required in related items such as disclosures and definitions of “cancel” or “transfer.” We believe the IASB should be mindful of the impact that measurement and scope decisions in this project may have on other key projects currently under revision (e.g. insurance and revenue recognition).

## Detailed Comments and Positions

### *Initial Measurement*

As it relates to the initial measurement of a liability, this ED would require 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. The amount the entity would rationally pay to be relieved of an obligation is the lowest of:

- (a) The present value of the resources required to fulfill the obligation measured using the expected value approach;
- (b) The amount that the entity would have to pay to cancel the obligation; and
- (c) The amount the entity would have to pay to transfer the obligation to a third party.

Further, the ED indicates that an entity might be unable to cancel some obligations within its scope. The ED indicates that if there is no evidence that an entity could cancel or transfer an obligation for a lower amount, the entity measures the liability at the present value of the resources required to fulfill the obligation.

The ED also indicates that the amount an entity would have to pay to cancel or transfer an obligation would include any costs of cancellation or transfer.

In considering the application of the initial measurement criteria above, we have the following observations or comments:

- 1) Definition of, and Evidence Required for, Cancel or Transfer Transactions – The ED does not define the meaning of “cancel” or “transfer.” The economics of a transaction differ depending on whether the obligation has been extinguished (no uncertainty remains) or simply transferred to another party (in which case both the transferor and the transferee may retain risk). We believe it is essential to define the criteria that constitute a cancellation or transfer of an obligation so that the accounting accurately reflects those underlying economics. Paragraph 43 of the Working Draft notes that if a liability is cancelled or transferred it is derecognized, making a clear definition critical to the appropriate balance sheet treatment.

Supplementally, when we met with IASB Board Members and staff on 27 May, we highlighted the importance of interproject consistency. The measurement criteria in IAS 37, and its “fulfillment model” approach will be a reference point for measuring obligations in the insurance contracts project. In the context of insurance contracts the terms “cancel” and “transfer” have meanings which have long been debated, connote very different accounting treatment, and which are currently being discussed – at least the definition of transfer – as a part of the insurance contracts project. Accordingly, we think it important to define what “cancel” or “transfer” mean in the context of this ED and the related liabilities to ensure when applying the principles set forth in the ED that entities understand what such alternatives mean and how to value them. We would also note that Paragraphs 37 through 42 of the Working Draft address how to account for reimbursement rights. Insurance contracts are highlighted as a type of third party reimbursement right rather than a transfer. The

standard should explicitly state whether “cancel” means “extinguish.” The Working Draft needs to more clearly articulate when a contract has what it would consider to be reimbursement rights versus when a contract is deemed to be a transfer . The Working Draft also needs to define what constitutes a cancellation of liabilities. Without these improvements, we fear it will be difficult to appropriately identify and value such alternatives.

Further, we would note, that when obligations under insurance contracts are transferred the liabilities are not derecognized. Rather, the obligations are retained and the amounts transferred are reflected as recoverables on the balance sheet – similar to the guidance provided in Paragraphs 37 through 42 of the Working Draft related to reimbursement rights. Only in the case of legal novations of insurance contracts, which occur in very limited circumstances, are obligations removed from the balance sheet of the primary obligor. It seems inconsistent for liabilities which are less likely to be transferred and which could have greater subjectivity in their measurement to be derecognized under this ED when insurance obligations are derecognized in only very limited circumstances.

Finally, the ED does not provide guidance on the degree of due diligence an entity must undertake or its overall responsibility to determine “cancellation” or “transfer” values. Rather, it only requires that they be obtained when the values are believed to be lower. Specifically, we believe that the standard should discuss: (1) the nature and weight of evidence required of an entity to determine if an obligation is unable to be canceled or transferred, (2) the requirement for an entity to substantiate its assessment of whether a liability can be cancelled or transferred, and (3) the nature of evidence required to support the cancellation or transfer valuation, and it being lower.

- 2) Definition and Objective of Present Value of Resources Required to Fulfill – Present value computations differ depending upon their inputs. It is not clear from a review of the ED as to whether the present value computation is meant to arrive at a “cost approach”, “entity specific value approach”, or a “third party exchange value”. Those proposing the alternative view on profit margins do not appear to be advocating for a “value based approach.” Rather, it would appear they are advocating for a “cost approach.” Further, the ED requires the inclusion of “internal legal costs” in the present value computation when a liability is fulfilled by making a payment but does not include the addition of a profit margin on such “legal services.” The ED would appear to be inconsistent in what the present value computation yields when addressing liabilities fulfilled by making a payment and those fulfilled by completing a service. Overall, it appears there may be fundamentally different views among the IASB members and inconsistencies within the ED on the objective of the present value measurement required by Paragraph 36B(a).

We would note, however, that profit margins are not the only element of the present value computation which raise questions regarding the definition and objective of the present value measurement required by Paragraph 36B(a). Further clarity on risk margins and the discount rate – their definitions and component parts – is also necessary. For example, if risk margins include a provision for the uncertainty regarding the amount and timing of cash flows, the present value computation may result in an entity-specific valuation approach. If



risk margins are defined even more broadly to include a market risk premium the computation would approximate a third party exchange value. Similarly, clarity on discount rate is required as discounting at an own credit rate may more closely approximate a third party valuation approach.

- 3) Application of the Measurement Criteria – While we understand that the mechanics of the comparison in Paragraph 36B require the preparer to record the lowest of what would be rationally paid, it is not clear whether the objective of the measurement criteria will be achieved unless there is further clarification on the “fulfillment” present value computation in Paragraph 36B (a) and greater clarity on the definitions of “cancel” or “transfer”.

While we believe greater definition of “cancel” or “transfer” price is required to obtain and effectively compare these valuations with a fulfillment value, it is clear “cancel” or “transfer” measurements will always include a profit margin for the third party assuming the obligation. Even if all other elements of the present value of fulfillment calculation and the cancel or transfer alternatives are equal, without the inclusion of a profit margin in the present value computation, the comparison required by the initial measurement criteria in Paragraph 36B would have to result in the present value calculation of the resources required to fulfill always being lower. This would result in the outcome of the initial measurement comparison nearly always being the fulfillment alternative.

While we understand the "lowest of" approach to initial measurement, we are concerned that the comparison may not be valid if definitions are unclear and inconsistent measurement biases the comparison. We believe that market inputs, risk margins, and profit margins should be incorporated into all three measurements.

Additionally, the composition of the present value calculation will define the preparer's requirement to seek “cancel” or “transfer” prices. If elements such as profit margin are not included in the fulfillment measure there is unlikely to be a “cancel” or “transfer” price which would be lower, and as such, the preparer is unlikely to go through the exercise of obtaining such “cancel” or “transfer” prices to conduct such a comparison due to a high degree of confidence that the fulfillment measure will be lower. As a result, this calls into question whether in practice this standard will be applied as a “lower of” approach or if the default step will be to assume the use of the fulfillment measure.





## ***Fulfilment Using Present Value Approach***

### *Expected Loss Technique*

We are supportive of the expected value or expected loss technique as a means of measuring obligations or impairments when outcomes are uncertain, because we believe the expected loss technique considers the impact of events or losses over the entire life of a contract or obligation and has the potential to incorporate and recognize the impact of future events which were incorporated into the pricing of a contract or the estimation of loss. The incurred loss model, in contrast, can only recognize losses after they have occurred. Accordingly, we believe an expected loss model should produce more predictive results and better reflect the pricing assumptions in contracts or, for non-contractual obligations, the estimated range of possible outcomes. The expected loss approach is more consistent with how market participants attempt to price in uncertainty than the incurred loss approach.

Like the incurred loss model, the expected loss approach requires estimates that are subject to error. We recognize the inherent difficulty of assigning values and probabilities to outcomes which may be difficult to estimate and that the actual amount paid by an organization is likely to differ from the expected value of the outflows. However, we do not believe these are reasons not to utilize this model. The assignment of values and probabilities may be subjective but we do not believe any more subjective than determining a point estimate. Further, the rigor of a probability-based process may require managements to more carefully consider all possible outcomes and the ultimate value of such obligations. Further, though expected value may not equate to the actual cash flow ultimately required to settle the obligation, as time progresses and uncertainties resolve themselves the expected value and amounts paid should converge as uncertainties abate and outcomes become more certain. The disclosure of the development of such expectations, along with the key information regarding the computations themselves, can provide decision-useful information to investors.

However, we believe that the expected loss approach requires appropriate disclosures to produce the most meaningful information for investors and alleviate the market mispricing of the securities of entities with such obligations. Investors need:

- a robust discussion of the nature of the obligation or uncertainty along with disclosures regarding the types, amounts and timing of the expected outflows required to satisfy the obligation;
- the extent to which such expected outflows were determined by reference to market-based inputs; the probabilities and distributions of the expected outcomes;
- the risk margins assumed; and the method used to determine, and level of, discount rates utilized.

For those who believe the most likely outcome is the better measurement of such obligations, we would suggest having management disclose their view of the most likely outcome in the notes. This information, combined with disclosures of probabilities and distributions of outcomes utilized in the expected loss computation, is decision-useful information to investors. Further, as it relates to disclosures, investors need information that enables them to see the development of management's estimates over time. Sufficiently transparent disclosures, combined with a track record of management effectively estimating such losses – or





incorporating new information into the estimation of such losses – would facilitate investor understanding and effective pricing of such obligations and the valuation of the obligors’ securities. See “Disclosures” section that follows for more specific information on the disclosures we recommend.

### *Risk Margins*

In establishing the value of the obligation based on the expected loss, an entity is to consider the risk that the actual outflows might ultimately differ from those expected by applying a risk adjustment. Paragraph B15 of the ED states that this risk adjustment measures the amount, if any, that the entity would rationally pay in excess of the expected present value of the outflows to be relieved of this risk, but the ED does not indicate the circumstances under which such adjustment would be needed nor require the adjustment in all circumstances.

When the amount and timing of cash flows are certain, the present value technique is a mathematical device to equate those cash flows using a discount rate (see separate discussion of discount rate) to a single value. However, when uncertainty regarding the amount and timing of the cash flows is incorporated into the present value computation the question arises as to whether a risk margin is meant to reflect the uncertainty in the amount and timing of the cash flows associated with the liability or whether the risk margin reflects the compensation a third party would require to assume that uncertainty.

As written in the ED, we believe that the risk margin could be interpreted as either an adjustment to incorporate:

- uncertainty about the extent to which an entity’s probability estimates are accurate;
- a benefit for transferring the risk (e.g. market risk premium); or
- an additional safety margin.

We believe greater clarity is required to define whether the risk margin is meant to adjust for the dispersion of probabilities around the expected outflow estimates (or is this incorporated fully in the expected value technique) or whether the risk margin is meant to compensate a third party for assuming this uncertainty or both. The objective should be to have all risk elements priced once (but only once) and for preparers, auditors, and investors to have a clear understanding of where each type of risk is included.

Our view is that the present value computation required by Paragraph 36B (a), should incorporate uncertainty in the amount and timing of the cash flows associated with the liability as well as the compensation a third party would require to assume that uncertainty. We therefore believe the new standard should contain a more thorough explanation regarding the nature and purpose of risk margins along with guidance regarding when risk margins should be incorporated into an expected loss computation and how they should be measured. We also believe risk margins should be explicitly computed and disclosed. Without guidance on the principles of risk margins or any disclosure of the amount of such margins, we believe:

- it is likely that there will be significant diversity in practice,
- risk margins will be used to inappropriately bias the outcome of the present value calculations, and



- the result of the expected value measurement approach will be no less subjective than management’s measurement of the most likely outcome.

We also have concerns regarding the method by which risk margins might be incorporated into the expected loss computation. We have historically supported an explicit approach to assumptions; that is, assumptions should stand on their own and not be blended into other assumptions. Paragraph B16 establishes three alternatives for including a risk adjustment with a reference to the most appropriate method depending upon the nature of the risk and the pattern of the estimated future outflows. The ED allows risk margins to be incorporated into the expected outflows, the discount rate, or added to the final expected value computation. Providing choices regarding the alternative means of incorporating risk margins contributes to inconsistencies in application of risk margins, the potential to inadvertently omit or double-count risk margins, lack of transparency regarding the explicit inclusion of these judgments and a lack of comparability.

For example, if one entity includes risk margins in the discount rate and another includes risk margins as an addition to the expected value computation, the subsequent measurement borrowing cost (accretion of discount) would differ between the entities. One entity’s borrowing cost would include the amortization of interest expense and the other will include amortization of interest expense and risk margins. We believe that risk margins should be an explicit addition to the expected value computation (Alternative C) and they should be separately disclosed. We would also expect that the changes in risk margins over time should be disclosed to reflect, for example, that as outcomes become more certain that such margins decrease.

#### *Profit Margins*

Paragraph B8 of Appendix B, specifies that for obligations fulfilled by undertaking a service, an entity would measure the liability as the amount it would rationally pay a contractor at a future date to undertake the service on its behalf. In so doing, the relevant outflows to be measured would either be the market price for the service, or if there is no market, the amount the entity would charge another party to undertake the service which would include not only costs incurred, but also a margin it (the entity with the obligation) would require to undertake the service for another party.

As noted previously in this letter, the resolution of this issue by the IASB depends significantly upon their view of the objective of the present value measurement in Paragraph 36B(a). Is it a “cost approach”, “entity specific value approach”, or a “third party exchange value?” Those holding the alternative view appear to believe the measurement objective is more of a “cost approach.”

We support measuring liabilities based on market-based measurements for such services which will include both a risk and profit margin. When an external party is willing to assume the obligation, their price will include an expected profit margin as well as a risk margin. If the measurement excludes these components, it will not be comparable to the other measurement alternatives (i.e. cancel or transfer).



### *Discount Rate*

We agree with Paragraph B14 of the ED, which states that the expected outflows shall be discounted to their present value using rates that reflect the current assessments of the time value of money and risks specific to the liability. As noted previously, we do not agree that alternative approaches to including risk margins – including through adjustment of the discount rate – in the expected loss computation should be allowed as such approaches make identification of explicit risk margins difficult and reduce comparability between organizations.

We believe that the proposed standard should provide greater clarity on how the discount rate used in the measurement of the fulfilment obligation is derived. In particular, we believe that the proposed standard should better describe the relationship between the characteristics of the liability including the risk of uncertainty (risk margin and/or market risk premium), the obligor's own credit risk and the risk free rate. Because an entity is to consider the risk that the actual outflows of resources might ultimately differ from those expected, and include a risk adjustment for this, it would appear that the discount rate would be the risk free rate; however, if there also exists the notion of a comparison of fulfilment to cancellation or transfer, this would imply consideration of a market risk premium and the own credit of the obligor by a third party agreeing to assume the obligation. Said differently, one of the characteristics or risks specific to the liability by a third party agreeing to assume the obligation is that it is an obligation of the transferee. However, we note that the ED is silent on whether the discount rate includes items such as own credit risk.

As more fully described later in this letter, disclosure of the discount rate, the development of the discount rate, assumptions and changes between reporting periods is integral to a full understanding for the user.

### *Subsequent Measurement*

According to the ED an entity adjusts the carrying amount of a liability at the end of each reporting period to the amount that it would rationally pay to be relieved of the present obligation at that date and changes in the carrying amount of a liability resulting from the passage of time are recognized as a borrowing cost.

We agree with the notion that changes associated with the passage of time should be reflected as a borrowing cost. We note that the ED is silent on where changes in the liabilities are recorded or disclosed for other than the passage of time. We believe changes in assumptions, which would include changes in the discount rate, should be shown as a component of operating expense and the line item in the statement where it is recorded should be disclosed.

We request that the new standard require a detailed disaggregated rollforward – as described in the “Disclosures” section of this letter – as details of the original estimate as well as the development of management expectations are important for users to evaluate the reliability of management's estimates and the effects of measurement uncertainty on performance measures. Increasing the reliability of such estimates can be expected to reduce the market penalty often applied to the securities of entities with highly uncertain obligations.



### ***Onerous Contracts***

In principle, we believe that a comprehensive standard on the measurement of liabilities should not provide for exceptions. With the proposed exception, if a contract within the scope of IAS 18, *Revenue*, and IFRS 4, *Insurance*, (both due to be replaced) is determined to be onerous it would be measured by reference to the costs to fulfil the obligation rather than the costs the obligor would pay a contractor to fulfil the obligation. This will result in inconsistent measurements. It will result in onerous contracts with customers (i.e. contracts where management performs its business activities and seeks a profit margin) not including a profit margin whereas obligations which are not directly related to revenue producing activities and therefore, covered by this standard including a profit margin.

This will result in liability measurements which not only lack comparability but which ignore the original business purpose of the contracts and which are the very contracts which are most likely to have a market-based pricing reference. Under the ED's proposals, an entity would recognize a hypothetical profit on non-customer related obligations but not on customer related obligations, which is neither consistent nor economically intuitive.

### ***Disclosures***

We urge the Board to require effective disclosures to supplement the measurement of the liabilities addressed by the ED. We have reviewed the disclosure requirements included in paragraphs 44 through 55 of the Working Draft, considering what additional disclosures should be included related to the proposed changes in measurement. Presently, the Working Draft includes very general and limited disclosure requirements regarding the nature of the obligation (Paragraph 45(a)), a high-level rollforward requirement (Paragraph 49(a)), and a requirement to disclose that amount or timing for future outflows of resources along with major assumptions regarding future events (Paragraph 49(c)). We agree with the (Paragraph 49(b)) requirement to disclose the expected timing of the outflow of resources, but we highlight challenges related to such disclosures below. Supplementally, we are concerned that many entities will avail themselves of the prejudicial exemption in Paragraph 55. Our comments on the disclosures in the Working Draft are limited to those related to measurement of obligations and not those included in Paragraphs 50 through 54.

We believe the disclosures described in the following sections should be included in any final standard as they are an integral part of the process of communicating the nature of the liability to users. Our recommendations are in the areas of disaggregation, initial measurement, expected loss assumptions, risk margin, profit margin, discount rate, and the inclusion of a rollforward, which can effectively communicate to users changes in the nature of the liability, its measurement, and management's assumptions over time.

### ***Disaggregation***

Paragraph 46 of the Working Draft allows the aggregation of obligations to form a class where the nature of the liabilities is sufficiently similar. We believe that many of the obligations covered by this proposed standard are inherently unique and we want to emphasize that appropriate disaggregation to enable users to understand the measurement and development of such liabilities is essential for efficient market pricing of such obligations. We support



disclosures that disaggregate the obligation recorded and the approach and assumptions used in measuring the obligation as described in the following sections.

### *Initial Measurement*

In addition to a robust discussion of the nature of the obligation and the related uncertainties associated with its measurement, we believe an entity should disclose the measurement basis utilized (fulfilment, cancel, or transfer value). Further, if the measurement approach changes from one period to the next, we believe the entity should disclose the change in approach, the reasons for the change, and its impact on the estimated obligation.

When a cancellation or transfer valuation is utilized, we would expect that management describe how they arrived at such cancellation or transfer values. This description should include the nature and market for cancellation or transfer of such obligations and the evidence obtained to support such values. Given that cancellation or transfer were the lowest price alternatives, and the entity is measuring the obligation at this value rather than choosing to actually cancel or transfer the obligation and thereby derecognizing the obligation, we believe it would be appropriate for the entity to disclose why they chose not to cancel or transfer the obligation.

When an entity actually cancels or transfers an obligation, and in accordance with Paragraph 43 of the Working Draft derecognizes the obligation this should be disclosed. The nature of the derecognition (cancel or transfer), the amount of the expense recognized as well as where such expense is reflected the financial statements should be disclosed. The amounts should also be included in the rollforward described below.

If the fulfilment alternative is utilized, we would expect the disclosures included in the subsequent section to be disclosed.

### *Fulfilment Using Present Value Approach*

We request disclosure of the elements of the expected loss calculations utilized in a fulfilment based approach. Outlined below are our suggested disclosures:

- 1) Cash Outflows – The nature, timing and amount of the expected cash flows. Significant types of costs included in the computation and the extent to which such costs reflect fulfilment by making a payment or providing a service should be disclosed.
- 2) Probabilities and Distributions – The number of outcomes, their associated probabilities and the resulting distribution of the outcomes utilized in the computation. This will enable users to understand possible alternative outcomes other than the single value arrived at through the expected value computation.
- 3) Most Likely Outcome – Provide a disclosure of management’s most likely outcome.
- 4) Risk Margins – The amount of any risk margin included in the expected value computation, what such risk margin represents, how the risk margin was measured and how such margin was incorporated into the estimate.
- 5) Profit Margins – For fulfilment obligations required to be completed by way of providing a service, disclosure should be made of the extent to which market-based prices are available for the services required to be undertaken and the extent to which such prices have been utilized or the extent to which profit margins have been incorporated because market prices



for such services are not available. Where markets for required services do not exist, entities should explicitly disclose the amount of the profit margin included in the computation of the obligation and how such profit margin was determined and measured.

- 6) Discount Rate – The discount rate and how it was developed, including whether it represents the risk free rate, some adjustment for risk margin or the entity’s own credit should be disclosed.
- 7) Expected Timing of Payments – We agree with disclosure requirement in Paragraph 49(b) of the ED regarding the need to disclose the expected timing of any resulting cash outflow of resources; however, it is not clear when using an expected loss technique how this will be practically implemented as the expected value amount of the obligation does not equate to the amount of expected payments because of the application of probabilities, as well as the time value of money. Until the uncertainties are resolved, the amount of the anticipated cash outflows will differ, possibly substantially, from the amount of the obligation recognized.
- 8) Actual Cash Payments vs. Expected Payments – As actual cash payments are made the difference between the actual versus expected payments should be disclosed to allow users to understand the development of expectations to actual payments.

#### *Subsequent Measurement*

We recognize that Paragraph 49(a) of the ED includes a requirement to include a rollforward of the liability from the beginning to the end of the reporting period; however, we do not believe the rollforward as proposed is sufficiently detailed to enable users to understand the progression and development of the liability from initial to subsequent measurement. As noted previously, if the approach to measuring the obligation changes between periods, this should be disclosed.

Additionally, changes in key assumptions and the reason for such changes should be described as text supplementing the rollforward. Specifically, current period adverse, or favourable, development should be explained.



	<u>20XX</u>
<b>Liability - Beginning of the Period</b>	<u>X,XXX</u>
<i>Acquisitions or Dispositions Occurring During the Period</i> <sup>(1)</sup>	XXX
<i>Expected Cash Flows for Losses:</i>	
Existing Obligations at Beginning of the Period:	
Current Period Development of Current Period Expected Cash Flows	XXX
Current Period Development of Future Period Expected Cash Flows	<u>XXX</u>
	XXX
New Obligations Arising During the Period <sup>(2)</sup>	<u>XXX</u>
	XXX
<i>Payments:</i>	
Associated with Obligations Existing at Beginning of the Period	(XXX)
<i>Discount Rate:</i>	
Obligations Existing at Beginning of the Period:	
Interest Cost Arising from the Passage of Time	XXX
Impact of Changes in Obligation Due to Change in Discount Rate	<u>XXX</u>
	XXX
New Obligations Arising During the Period - Impact of Discount Rate <sup>(2)</sup>	<u>XXX</u>
	XXX
<i>Risk Margins:</i>	
Associated with Obligations Existing at Beginning of the Period	XXX
Associated with New Obligations Arising During the Period <sup>(2)</sup>	<u>XXX</u>
	XXX
<i>Profit Margins:</i>	
Associated with Obligations Existing at Beginning of the Period	XXX
Associated with New Obligations Arising During the Period <sup>(2)</sup>	<u>XXX</u>
	XXX
<i>Amounts Derecognized During the Period:</i>	
Existing Obligations at Beginning of the Period <sup>(3)</sup>	(XXX)
<i>Impact of Exchange Rate Movements</i>	XXX
<b>Liability - End of the Period</b>	<u><u>X,XXX</u></u>

- <sup>(1)</sup> Reflect acquisitions or dispositions as of date of the transaction. Development before or after that date should be included in the appropriately labeled sections which follow.
- <sup>(2)</sup> Reflect new obligations assuming liability arose at the end of the period. If payments made during the period which are included in the expense disclose as a footnote to the rollforward. All assumptions regarding risk margins, profit margins, and discount rate should be as of the end of the period.
- <sup>(3)</sup> For obligations existing at the beginning of the period, include rollforward of amounts up to date of derecognition in the preceding sections of the table. For obligations arising an derecognized during the period, disclose as a footnote to the rollforward.

### ***Other Considerations in Revising Measurement Criteria***

We agree with the view expressed by two members of the IASB in the ED's Alternatives Views (Paragraph AV 7) that measurement objectives and methods on the one hand and recognition criteria on the other hand are closely related. In considering the modifications proposed in the ED related to measurement, we believe it is important that the IASB recognize that linkage. Further, the nature of certain of the measurement changes in the ED may necessitate changes in other areas of the Working Draft. For example, the Working Draft may need revisions to include disclosures of elements of the measurement method and to clarify the definitions and accounting (i.e. derecognition) for cancellations and transfers. Finally, we believe the IASB should





recognize that the measurement and scope decisions in this project have bearing on other key projects currently under revision (e.g. insurance and revenue recognition).

### **Closing Remarks**

If you, other members of the IASB or your staff have questions or seek further elaboration of our views, please contact either Matthew M. Waldron by phone at +1.434.951.5321, or by e-mail at [matthew.waldron@cfainstitute.org](mailto:matthew.waldron@cfainstitute.org), or Sandra J. Peters by phone at +1.212.754.8350, or by e-mail at [sandra.peters@cfainstitute.org](mailto:sandra.peters@cfainstitute.org).

Sincerely,

*/s/Kurt N. Schacht*

Kurt N. Schacht, JD, CFA  
Managing Director  
Standards & Financial Markets Integrity Division  
CFA Institute

*/s/ Gerald I. White*

Gerald I. White, CFA  
Chair  
Corporate Disclosure Policy Council

cc: Corporate Disclosure Policy Council

CFA Institute is pleased to provide answers to specific questions as follows:

***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?***

For our comments related to this question, refer to the “Initial Measurement” and “Subsequent Measurement” sections within the body of the letter.

***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?***

For our comments related to this question, refer to the “Profit Margins” section within the body of the letter.

***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?***

For our comments related to this question, refer to the “Onerous Contracts” section within the body of the letter.