General comments

We welcome the FASB decision to seek views from its own constituents on the concepts contained in the IASB Exposure Draft of proposed amendments to IAS 37.

In our response to the IASB, we welcomed the Exposure Draft discussion of possible new approaches to provision and contingency accounting. We were however concerned that, whilst certain policies would converge with US GAAP, there would also be a significantly greater divergence than at present from the requirements of FAS 5 "Accounting for Contingencies." Therefore we agree that this area be part of the conceptual framework project.

We believe that there is an element of probability in the recognition of obligations as well as with the measurement once recognition is determined to be appropriate. The probability consideration in recognition is related to the confidence level required of financial statement information to be utilised by investors as a basis of investment decisions.

Similarly presented probable estimates of assets or liabilities may vary significantly in the precision of the estimate. The FAS 5 distinction between contingent assets or liabilities requiring disclosure and those requiring recognition in the financial statements is responsive to the readers' needs in this regard. The proposed standards do not appear to contain such a distinction.

For measurement purposes we believe that the consequent measurement of obligations through summation of probability-weighted expected cash flows would work well when applied to a class of liabilities. However such statistical methods are sometimes limited in their ability to produce meaningful outcomes for small populations. Our response to Question 9 therefore reflects our concern that the proposed application of this method to single events could lead to misleading reporting in financial statements.

As discussed in our response to Question 4, we believe that the proposed inclusion of contingent assets within IAS 38 would result in an inappropriate balance sheet classification and also lead to greater inconsistency between the treatment of assets and liabilities arising from similar sources.

Due to the direction of the Exposure Draft including various liabilities of low probability (i.e. significantly lower than the maximum exposure due to a wide range of possible outcomes), we believe that the cost to financial statement preparers of recording and constantly remeasuring this information would far outweigh the benefit to users.
Specific questions asked

Question 1 – Contingent assets

Do you agree with eliminating the notion of contingent asset? If not, why not?

We agree: the term is confusing and misleading given the IAS and FASB Frameworks.

Question 2 – Contingent assets

Do you agree with the IASB’s analysis of unconditional and conditional rights in contractual settings, as summarized in paragraphs 30 and 31 of this Invitation to Comment and paragraphs BC10-BC13 of the IASB Exposure Draft? If not, why not?

We suggest simplifying the concept of contractual or other events giving rise to both unconditional and conditional rights, as illustrated by our response to question 3 below.

Question 3 – Contingent assets

If you answer yes to question 2, do you agree that the IASB has appropriately applied the notion and supporting reasoning referred to therein in the analysis of Examples 1-3 in paragraphs 33-35 of this Invitation to Comment? If not, why not?

Concerning Example 1, a legal claim related to a past event (or alleged past event) could instead be seen as giving rise to only an unconditional right to have the claim considered by the court. The future court decision then confirms the measurement of this same right.

In Example 3 where an entity is negotiating a contract with a new customer, we suggest that the specific process of negotiation gives rise only to a conditional asset. Until the contract is signed, the entity can walk away from the negotiating table without commitment, risk or reward.

Whilst the Example 3 analysis also identifies an unconditional asset in the economic value of a developing contractual relationship, this is in our view an incidental item that should not be seen as closely linked and should be excluded from the example. Whenever two entities interact – whether to dispute a legal claim (Example 1), apply for an operating license (Example 2) or negotiate a contract (Example 3) - a tenuous unconditional asset or liability could often be inferred due to an improvement or decline in the entities’ business relationship.

Question 4 – Contingent assets

Do you agree with the IASB’s proposal to classify as intangible assets those unconditional rights that are associated with conditional rights and that satisfy the definition of an asset, without shifting the consideration of the uncertainty surrounding the conditional rights from recognition to measurement?

We disagree: only those items previously described as contingent assets that satisfy the existing IAS 38 definition of an “intangible asset” should be within the scope of IAS 38. IAS 38 describes an intangible asset as an identifiable non-monetary asset without physical substance held for use in the production or supply of goods or services, for rental to others, or for administrative purposes.
There are other items that previously met the definition of a contingent asset, such as a claim that an enterprise is pursuing through legal processes, where the outcome is uncertain, which would not come under the guidance of IAS 38.

We do not agree that uncertainty as to carrying amount affects the underlying nature of an asset in such a way that it becomes intangible. We also disagree with the resulting greater inconsistency that the Exposure Draft would introduce between the recognition criteria and balance sheet classification of assets and liabilities arising from similar sources.

The proposed IAS 38 amendments comprise a discussion of conditional and unconditional rights, consistent with the proposed changes to IAS 37. However the proposed accounting treatment then, inconsistently, follows the unchanged IAS 38 paragraphs 21 to 24 – i.e. if future economic benefits are probable, recognise the intangible asset and measure initially at cost.

We believe that “contingent assets” should either be treated in a manner consistent with that of “contingent liabilities” or that any differing approach be justified. In the case of a lawsuit, for example, any liability recognised by the defendant should theoretically be equal and opposite to the asset recognised by the plaintiff, given similar assessments and measurements of the outcome – or, if not, the reasons for differing treatment (for example the view that asset recognition should require a higher level of certainty than required for liabilities) should be fully supported by the underlying conceptual framework.

Paragraph BC18 states that the IASB decided that revisiting the IAS 38 requirements was outside the scope of the [short-term convergence] project. This seems to imply that the treatment proposed in the ED may have been determined by a practical need to limit project scope, rather than being seen as the ideal accounting solution. If so, it should not form the basis for any revision of the conceptual framework.

Question 5 – Contingent liabilities

Do you agree with eliminating the notion of contingent liability? If not, why not?

We agree with the elimination of the term contingent liability.

Question 6 – Contingent liabilities

Do you agree with the IASB’s analysis of unconditional and conditional obligations in contractual settings, as summarized in paragraphs 39 and 40 of this Invitation to Comment and paragraphs BC24-BC28 of the IASB Exposure Draft? If not, why not?

We suggest simplifying the concept of contractual or other events giving rise to both unconditional and conditional rights, as illustrated by our response to Question 7 below and as previously discussed (Questions 2 and 3) in relation to contingent assets.
Question 7 – Contingent liabilities

If you answer yes to Question 5, do you agree that the IASB has appropriately applied the notion and supporting reasoning referred to therein in the analysis of the example in paragraph 41 of this Invitation to Comment [concerning an entity that is a defendant in a lawsuit]? If not, why not?

We suggest simplifying the concept of legal claims giving rise to both an unconditional obligation (to stand ready) and conditional obligation (to pay any penalties imposed). A claim related to a past event (or alleged past event) could instead be seen as giving rise to only an unconditional, stand-ready obligation. The future court decision then confirms the measurement of this same obligation.

Question 8 – Probability Recognition Criterion

Do you agree with omitting the probability criterion for recognition of nonfinancial liabilities? If not, why not?

We believe that the approach does not acknowledge the degree of confidence required for financial statement information to be useful to investors. In our view there is an element of probability in the recognition of obligations as well as with the measurement once recognition is determined to be appropriate. The probability consideration in recognition is related to the confidence level required of financial statement information to be utilised as a basis of investment decisions.

It should be noted that the IASB Exposure Draft creates a divergence from US GAAP in the case of ‘reasonably possible’ liabilities, which would be recognised only under IFRS. Whilst the same recognition issue applies to remote liabilities, our assumption is that these anyway would be valued at zero during the measurement process.

Due to the direction of this Exposure Draft including various liabilities of low probability, we believe that the cost to financial statement preparers of recording and constantly remeasuring this information would far outweigh the benefit to users.

Question 9 – Measurement

Do you agree with the proposed measurement requirements for nonfinancial liabilities? If not, why not?

We agree that the expected cash flow approach is an appropriate basis for measuring a non-financial liability for a class of similar obligations, since the overall cash flow estimate is likely to be realistic, i.e. in line with the actual result. However, whereas application of the proposals to a class meets the “probable” requirement of the IASB Framework (paragraph 83), we believe that this may not always be the case for a single obligation.

The reasonableness of a probability-based approach is dependant upon having a sufficiently large population. Application to a single obligation (such as the example given in paragraph BC81) may produce a liability that is not helpful for accounts users, differing very significantly as it does from the actual, realised outcome.
The Exposure Draft (paragraph BC 81) gives the example of a single CU 1 million legal claim, which has a 60% chance of success. Measurement as proposed would result in a CU 600,000 balance sheet liability – a value that is likely to differ very materially from the actual outcome, being either CU 400,000 understated or CU 600,000 overstated. In such cases we would instead prefer to make appropriate disclosure.

Whilst the proposal could be seen as strictly following the fair value approach, we suggest that applying this as an overriding principle should in all cases be subject to testing whether the resulting outcome is reasonable and is useful to investors.

We also suggest that it may not in reality be possible to transfer a single obligation on a stand-alone, probability-based price. A third party would not rationally assume the obligation without possessing sufficient other claims to create a class for which the overall outcome could be realistically forecast.

We therefore propose that the best estimate for single obligations should continue to be based on the individual most likely outcome when the probability-based approach does not give reasonable results.

The Invitation to Comment notes that the Exposure Draft [paragraph 28] precludes recognition of a liability if the liability cannot be measured reliably. We would however point out that the Exposure Draft paragraph also states that such exceptions are extremely rare. The exception should in our view be widened to cover situations such as those discussed above, so that disclosure is the preferred route until a realistic estimate can be made.