January 3, 2006

Technical Director
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk
Connecticut 06856-5116

Re: Invitation to comment – Selected Issues Relating to Assets and Liabilities with Uncertainties – File Reference 1235-001

Dear Mr. Smith and Ms. Bielstein:

Citigroup is pleased to have the opportunity to respond to the Invitation to Comment on 'Selected Issues Relating to Assets and Liabilities' (the 'IC') released by the Financial Accounting Standards Board ('FASB' or 'the Board') in September 2005. We support the Board's continuing efforts in working with the International Accounting Standards Board (the 'IASB') and engaging with other relevant parties throughout the world in jointly developing new standards. We think that this is an important process to continue, and improve upon, to ensure that high quality standards that are of maximum use and reliability to users and preparers of financial reports.

Having reviewed the IC in detail, we believe that the adoption of the accounting model set out within this IC will have profound theoretical and practical implications for the financial reporting model – implications we are very uncomfortable with. In this letter we will outline our concerns and then reference the detailed questions in the IC to relevant portions of our comment letter dated October 28, 2005 on the IASB Exposure Draft, Provisions, Contingent Liabilities and Contingent Assets (proposed amendments to IAS 37) (attached).

Our primary source of unease is the apparently complete subjugation of recognition issues by measurement objectives. We do not believe that financial reporting is simply a measurement problem, for both theoretical and practical reasons. We are also very uncomfortable introducing fair value measurement concepts such as those contained in Concepts Statement No. 7, Using Cash Flow Information and Present Value in Accounting Measurements, in situations where the measurement (and particularly periodic remeasurement) is highly imprecise, such as legal settlement matters or other "classic" contingency situations.

While we accept the notion that low probability outcomes should be captured for certain assets and liabilities, we are extremely uncomfortable extending this theory to some contractual and all non-contractual rights and obligations, and certainly to events commonly thought of as "contingencies." The rights and obligations we are most concerned about often combine a significant lack of measurement precision with an inability to verify much of the resulting information. In many cases, we fear that this approach requires data that is so subjective that any resulting gains and losses recognized in income would be sufficiently unreliable so as to impair the integrity of the reported results and, because the data cannot be verified, reducing comparability, or audited.

We believe that the potential costs of implementing (and auditing) the requirements (if actually implemented) would not meet the cost versus benefit test set out in the Concepts Statements.
The removal of a probability-based recognition threshold would require companies to monitor, measure, and crucially, periodically remeasure an extremely large number of corporate events and other non-contractual items (potential events) that have a small probability of ever resulting in an actual cash inflow or outflow. While companies currently do identify some such items, they do not gather the large volumes of measurement and probability data that would be required to recognize these items in accordance with the proposal. It seems clear to us that the additional cost of gathering and maintaining such data would be substantial and could prove to be prohibitive for many companies.

We believe several fundamental issues must be satisfactorily resolved prior to further application of this framework:

- Is a recognition threshold appropriate and how does this interact with both relevance and reliability concerns?
- Is there a point where the precision of a (re)measurement becomes sufficiently poor that fair value is not the most appropriate (re)measurement attribute? Are there other situations where other measurement attributes are more appropriate?
- What is the appropriate unit of account for pools of homogeneous items and when is group accounting appropriate?
- What role do thresholds for recognition and measurement models have in managing the costs of gathering financial reporting information and what kinds of tradeoffs are appropriate?
- Pervasive use of fair value measurements and the auditing of them are inconsistent with the current skill sets of many members of the accounting profession. If the concepts in this proposal progress, how much time and what resources are needed to retrain a whole profession?

We would not consider it appropriate to make significant changes to existing Standards until significant progress on these fundamental issues is made and practical matters that arise from those debates are settled. We believe that none of these matters have been adequately addressed by the current proposal.

The FASB has posed a number of specific questions therein on which feedback was requested. Our views are set forth in the Appendix of this letter, which consists of Citigroup’s detailed comments responding on the proposed amendments to IAS 37.

We would be pleased to discuss our comments with you at your convenience.

Very truly yours,

Robert Traficanti
Vice President and Deputy Controller
Appendix: Detailed Responses to Specific Questions Raised by the IASB in their Exposure Draft ‘IAS 37 Provisions, Contingent Liabilities and Contingent Assets’

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<td>No. See Question 2 – Contingent liabilities, part (b).</td>
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<td>Question 2: 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?</td>
<td>No. See Question 3 – Contingent assets, part (b).</td>
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<td>Question 4: 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?</td>
<td>No. See Question 3 – Contingent assets, part (b).</td>
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<td>Question 5: Do you agree with eliminating the notion of contingent liability? If not, why not?</td>
<td>No. See Question 2 – Contingent liabilities.</td>
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<td>Question 6: 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?</td>
<td>No. See Question 2 – Contingent liabilities, part (b).</td>
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<td>Question 7: 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? If not, why not?</td>
<td>No. See Question 2 – Contingent liabilities, part (b).</td>
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Detailed Comments from Citigroup's October 28, 2005 letter commenting on the Proposed Amendments of IAS 37

Question 1 – Scope of IAS 37 and terminology

The Exposure Draft proposes to clarify that IAS 37, except in specified cases, should be applied in accounting for all non-financial liabilities that are not within the scope of other Standards (see paragraph 2). To emphasize this point, the Exposure Draft does not use 'provision' as a defined term to describe liabilities within its scope. Instead, it uses the term 'non-financial liability' (see paragraph 10). However, the Exposure Draft explains that an entity may describe some classes of non-financial liabilities as provisions in their financial statements (see paragraph 9).

a) Do you agree that IAS 37 should be applied in accounting for all non-financial liabilities that are not within the scope of other Standards? If not, for which type of liabilities do you regard its requirements as inappropriate and why?

b) Do you agree with not using 'provision' as a defined term? If not, why not?

Response to (a)

We support the Board’s intention to generate a standard that covers all liabilities that are not addressed by other Standards. However, we feel that the approach set out in this proposal is not appropriate for all contingent liabilities and non-contractual obligations. In our opinion the Board needs to identify all items that may fall within the scope of a proposed amendment to IAS 37 and consider them individually to determine whether any amended model is appropriate.

Response to (b)

We understand the Board’s decision not to use the word provision as a defined term, in the context of the recognition and measurement model set out in the ED. However, as we are recommending that the Board not adopt the principal elements of the proposed model, we would not recommend that this change be finalized in isolation.

Question 2 – Contingent liabilities

The Exposure Draft proposes to eliminate the term 'contingent liability'.

The Basis for Conclusions on the proposals in the Exposure Draft explains that liabilities arise only from unconditional (or non-contingent) obligations (see paragraph BC11). Hence, it highlights that something that is a liability (an unconditional obligation) cannot be contingent or conditional, and that an obligation that is contingent or conditional on the occurrence or non-occurrence of a future event does not by itself give rise to a liability (see paragraph BC30).

The Basis for Conclusions also explains that many items previously described as contingent liabilities satisfy the definition of a liability in the Framework. This is because the contingency does not relate to whether an unconditional obligation exists. Rather it relates to one or more uncertain future events that affect the amount that will be required to settle the unconditional obligation (see paragraph BC23).

The Basis for Conclusions highlights that many items previously described as contingent liabilities can be analyzed into two obligations: an unconditional obligation and a conditional
obligation. The unconditional obligation establishes the liability and the conditional obligation affects the amount that will be required to settle the liability (see paragraph BC24).

The Exposure Draft proposes that when the amount that will be required to settle a liability (unconditional obligation) is contingent (or conditional) on the occurrence or non-occurrence of one or more uncertain future events, the liability is recognized independently of the probability that the uncertain future event(s) will occur (or fail to occur). Uncertainty about the future event(s) is reflected in the measurement of the liability recognized (see paragraph 23).

a) Do you agree with eliminating the term 'contingent liability'? If not, why not?

b) Do you agree that when the amount that will be required to settle a liability (unconditional obligation) is contingent on the occurrence or non-occurrence of one or more uncertain future events, the liability should be recognized independently of the probability that the uncertain future event(s) will occur (or fail to occur)? If not, why not?

Response to (a)

We agree that the term “contingent liability” presently encompasses two different scenarios, i.e., that of a possible present obligation and a definite present obligation which is not recognized as it cannot be measured reliably. We therefore agree with the Board’s intention to eliminate the ambiguity of this term. However, as set out below, we have a number of serious concerns with the approach that the Board is proposing to address this point.

Response to (b)

We are deeply concerned by the model set out within this proposal for accounting for all non-financial liabilities. We note that the proposal sets out a single treatment for both contractual items (such as product warranties) and non-contractual legal obligations (such as lawsuits and legislation changes) and constructive obligations (such as promises to restore contaminated land), which are all fundamentally different in nature.

We accept that this underlying concept has some theoretical merit when applied to contractual items, as it is possible to identify the obligating event clearly. However, given the subjectivity and practical difficulties of the measurement requirements that are built on this foundation principle, we believe that this proposal will not result in information that is more useful to the users of financial statements than that which is required by the current version of IAS 37.

Our analysis has also led us to conclude that the proposed model will not be workable when applied to constructive obligations, due to insufficient guidance on what constitutes an obligating event. Taking the example of the contamination of land in a country where no environmental legislation exists, the proposal states that a liability should be recognized where a company 'has a widely publicized environmental policy ...and a history of honoring this published policy'. This example demonstrates an element of sophistry, as it does not take into account the uncertainty that is likely to exist, including whether any damage is a direct result of a company’s actions and whether its past actions support any such policy that may exist. Without sufficient guidance on how to address this 'element' uncertainty, the model cannot be applied to non-contractual and constructive obligations consistently.
We also believe that the interaction of this underlying principle and the probability criterion under this approach results in the proposal having more potential for abuse than is the case under current IAS 37. This can be illustrated by considering Examples 1 (a disputed lawsuit) and 2 (a potential lawsuit) that set out the following:

- For a disputed lawsuit, a liability exists from the date that legal proceedings are commenced; and
- For potential legal proceedings, a liability is recognized from the date that the underlying event that could lead to the proceedings occurred.

These examples imply that if an event happens that could possibly lead to a lawsuit being filed, before such legal proceedings are brought, the requirement to recognize a liability is driven by the entity’s expectation of a claim and management’s intention to dispute the claim. For example, an entity that believes that it may be subject to a substantive future legal claim as a result of a past event is extremely unlikely to recognize a liability as this implies an admission of guilt that could encourage legal proceedings to be started, and could adversely impact any proceedings that are brought. In contrast an entity that is confident that it will not, in reality, be subject to a substantive legal claim could record a liability in respect of a particular past event by simply representing that there is some possibility of legal proceedings being brought against them. Without the recognition threshold based on the probability criterion, this could provide management with simple tool with which to manage earnings. This will be extremely hard to enforce and audit in practice, as the existence of the past event and the likelihood of its leading to a claim will be very hard to detect and verify and the intention of management to dispute this will also be difficult to challenge.

Following our analysis we rigorously support the view of the dissenting Board member that the current proposal does not provide sufficient clarity on the definition of and conditions for an obligating event for the model to be workable in its current form.

We are also concerned by the likely reduction in disclosure of useful information relating to stand alone conditional obligations (i.e., where no corresponding unconditional obligation exists). Despite the Board’s comments in paragraph BC 32, it is our view that the proposed amendments will result in less clear and more fragmented disclosures of the uncertainties relating to recognized non-financial liabilities and unrecognized stand alone conditional obligations than was previously required for ‘contingent liabilities’ under the existing standard.

**Question 3 – Contingent assets**

The Exposure Draft proposes to eliminate the term 'contingent asset'.

As with contingent liabilities, the Basis for Conclusions explains that assets arise only from unconditional (or non-contingent) rights (see paragraph BC11). Hence, an asset (an unconditional right) cannot be contingent or conditional, and a right that is contingent or conditional on the occurrence or non-occurrence of a future event does not by itself give rise to an asset (see paragraph BC17).

The Basis for Conclusions also explains that many items previously described as contingent assets satisfy the definition of an asset in the Framework. This is because the contingency does not relate to whether an unconditional right exists. Rather, it relates to one or more uncertain
future events that affect the amount of the future economic benefits embodied in the asset (see paragraph BC17).

The Exposure Draft proposes that items previously described as contingent assets that satisfy the definition of an asset should be within the scope of IAS 38 *Intangible Assets* rather than IAS 37 (except for rights to reimbursement, which remain within the scope of IAS 37). This is because such items are non-monetary assets without physical substance and, subject to meeting the identifiability criterion in IAS 38, are intangible assets (see paragraph A22 in the Appendix). The Exposure Draft does not propose any amendments to the recognition requirements of IAS 38.

a) Do you agree with eliminating the term 'contingent asset'? If not, why not?

b) Do you agree that items previously described as contingent assets that satisfy the definition of an asset should be within the scope of IAS 38? If not, why not?

Response to (a):

We support the Board’s intention to eliminate the ambiguity of the term “contingent asset,” but again we do not support the approach that the Board is proposing to achieve this.

Response to (b):

In principle, we support the Board’s proposal that assets with a contingent element should be treated under IAS 38, as this requires a similarly high recognition threshold, i.e., that it is ‘probable’ that the expected future benefits will flow to the entity. However, from the Board’s comments in the ED, it is not clear to us how IAS 38 is implemented in conjunction with the proposed model of splitting a contingent asset into a conditional and an unconditional element.

Again we are uncomfortable with the proposed model, as we believe that it becomes unworkable when applied to pre-contractual items. For example, in the Basis for Conclusions the Board sets out the following as items that constitute unconditional rights that should be recognized as assets:

- The right to participate in bidding for a license;
- The right to have a claim for recovery of damages heard in court; and
- The unconditional right to the economic value of developing a customer relationship.

In our view, the above examples of what the Board considers to be unconditional rights illustrate the theoretical nature of the proposed model and seem again to imply sophistry. We are skeptical about the Board’s conclusions that these items meet the definition of an asset set out in the Framework, and do not believe that the guidance in the proposal is sufficiently clear on what would need to be recognized under the model. In our view the above examples also demonstrate that recognition under this model could again be based purely on management’s intentions, i.e., the intention to bid for a license or the intention to develop a customer relationship, which is virtually impossible to verify or refute. We can see that this model could give management greater control over the timing of recognition of an asset and could result in an asset’s being recognized earlier than under the existing model.
Question 4 – Constructive obligations

The Exposure Draft proposes amending the definition of a constructive obligation to emphasize that an entity has a constructive obligation only if its actions result in other parties having a valid expectation on which they can reasonably rely that the entity will perform (see paragraph 10). The Exposure Draft also provides additional guidance for determining whether an entity has incurred a constructive obligation (see paragraph 15).

a) Do you agree with the proposed amendment to the definition of a constructive obligation? If not, why not? How would you define one and why?
b) Is the additional guidance for determining whether an entity has incurred a constructive obligation appropriate and helpful? If not, why not? Is it sufficient? If not, what other guidance should be provided?

Response to (a)

We understand from paragraphs BC 57 to 60 that it was the intention of the Board to raise the threshold for the recognition of a constructive obligation. However, we do not feel that the wording in the standard itself makes this clear enough. We would therefore request that the Board include further guidance, within the standard itself, to clarify this point.

We do, however, believe that the intention of the Board to raise the threshold for the recognition of constructive obligations highlights a further inconsistency in the proposed model. As set out above, we are concerned that the ED proposals could lead to a lowering of the recognition threshold for pre-contractual assets below that required for constructive obligations. We would challenge whether this is appropriate and also question how the two items are separable given that they are both based on management intention. In fact, certain constructive obligations may be more probable of occurring than pre-contractual assets, yet only the latter is recognized under the model proposed in the ED.

Response to (b)

In our opinion, the additional guidance that the Board has provided is appropriate and helpful, subject to the comment made above.

Question 5 – Probability recognition criterion

The Exposure Draft proposes omitting the probability recognition criterion (currently in paragraph 14(b)) from the Standard because, in all cases, an unconditional obligation satisfies the criterion. Therefore, items that satisfy the definition of a liability are recognized unless they cannot be measured reliably.

The Basis for Conclusions emphasizes that the probability recognition criterion is used in the Framework to determine whether it is probable that settlement of an item that has previously been determined to be a liability will require an outflow of economic benefits from the entity. In other words, the Framework requires an entity to determine whether a liability exists before considering whether that liability should be recognized. The Basis notes that in many cases, although there may be uncertainty about the amount and timing of the resources that will be required to settle a liability, there is little or no uncertainty that settlement will require some outflow of resources. An example is an entity that has an obligation to decommission plant or to
restore previously contaminated land. The Basis also outlines the Board's conclusion that in cases previously described as contingent liabilities in which the entity has an unconditional obligation and a conditional obligation, the probability recognition criterion should be applied to the unconditional obligation (i.e. the liability) rather than the conditional obligation. So, for example, in the case of a product warranty, the question is not whether it is probable that the entity will be required to repair or replace the product. Rather, the question is whether the entity's unconditional obligation to provide warranty coverage for the duration of the warranty (i.e. to stand ready to honor warranty claims) will probably result in an outflow of economic benefits (see paragraphs BC37-BC41).

The Basis for Conclusions highlights that the Framework articulates the probability recognition criterion in terms of an outflow of economic benefits, not just direct cash flows. This includes the provision of services. An entity's unconditional obligation to stand ready to honor a conditional obligation if an uncertain future event occurs (or fails to occur) is a type of service obligation. Therefore, any liability that incorporates an unconditional obligation satisfies the probability recognition criterion. For example, the issuer of a product warranty has a certain (not just probable) outflow of economic benefits because it is providing a service for the duration of the contract, i.e. it is standing ready to honor warranty claims (see paragraphs BC42-BC47).

Do you agree with the analysis of the probability recognition criterion and, therefore, with the reasons for omitting it from the Standard? If not, how would you apply the probability recognition criterion to examples such as product warranties, written options and other unconditional obligations that incorporate conditional obligations?

Response

We have a number of serious concerns with the impact of the proposal on the probability criterion concept within the Framework. The proposal, while it argues that the current IAS 37 does not comply with the Framework, never the less proposes a significant change to the way the probability criterion is applied. In our view, the change is so significant that it constitutes a change to one of the basic concepts of the Framework itself.

It seems clear that such a fundamental change to the Framework of IFRS is likely to have far wider implications than just contingencies and so should be addressed through an overall consideration of the Framework guidance, as opposed to piecemeal when new standards are introduced. If conceptual changes are reflected in new standards prior to consideration and amendment of the Framework, this creates a significant risk of fundamental inconsistencies between the two, and increases the likelihood of future changes to amended Standards as a result of subsequent considerations of the Framework. In this context, we would highlight paragraph BC 112 of the current IFRS 3 where the Board has raised this same issue.

From a practical perspective, the consideration of the probability criterion set out in the proposal is likely to further contribute to the result that a larger population of liabilities will require recognition on the balance sheet. As discussed in question six, the combination of this fact and the subjective and uncertain nature of measurement techniques is likely to lead to the useful disclosure data provided under the current IAS 37 being replaced by vague and unreliable fair value information recognized in the income statement and balance sheet.

Not only will this change to the application of the probability recognition criteria lead to an increased number of items being recognized and fair valued, it will also result in entities having
to identify, assess and capture measurement data for a large new population of low probability items. Examples of new items that would need to be tracked might include liabilities for non-contractual refunds, to the extent they are not addressed by IAS 18, (e.g., find it cheaper and we will refund the difference offers), ongoing employee termination benefits, as well as customer relationships and the right to bid for licenses and exploration rights on the assets side.

We have also identified some concerns with how this proposal may impact accounting for loan commitments. Loan commitments outside the scope of IAS 39 (i.e., commitments to lend at a market rate that are not designated at fair value) are not recognized as a liability at fair value under the current version of IAS 37. The proposed model, however, would seem to indicate that loan commitments should be measured using the full probability weighted cash flow approach set out in the ED. We do not believe that this is an appropriate model for measuring loan commitments and recommend that the Board consider this issue.

Question 6 – Measurement

The Exposure Draft proposes that an entity should 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 (see paragraph 29). The Exposure Draft explains that an expected cash flow approach is an appropriate basis for measuring a non-financial liability for both a class of similar obligations and a single obligation. It highlights that measuring a single obligation at the most likely outcome would not necessarily be consistent with the Standard's measurement objective (see paragraph 31).

Do you agree with the proposed amendments to the measurement requirements? If not, why not? What measurement would you propose and why?

Response

As set out in our introductory comments and responses on the recognition approach we have a number of fundamental concerns with the measurement requirements that are being proposed, from a practical application and, to a lesser extent, a conceptual perspective. In our view the proposed measurement (in conjunction with the proposed recognition requirements) will reduce the understandability and the relevance of the financial statements with respect to non-financial liabilities by recording highly uncertain amounts in the income statement and balance sheet that are derived from subjective measurement techniques.

The current IAS 37 approach of measuring a single obligation at its most likely outcome is a practical approach that is already subject to uncertainty due to the subjective, and therefore unreliable, nature of data on the most likely conditional outcome. In our view, introducing the expected cash flow approach will significantly increase the subjectivity and uncertainty of measurement as the probability and expected cash flow data is even more difficult to obtain. Given this unavoidable fact, we do not see how such an approach, while potentially theoretically superior, actually 'reflects the current amount that the entity would rationally pay to settle the present obligation'. Indeed we consider it likely in many cases, particularly in relation to low probability events, that the proposed model, by definition, will result in non-financial liabilities being recognized at a different value to the value of the actual outflow of economic benefits.
This issue is underlined by the statement that 'except in extremely rare cases an entity will be able to determine a reliable measure of a liability' as the majority of items that were previously identified as contingent liabilities will be recorded under this model. We question the validity of this statement given the inherent uncertainty, and therefore unreliability, in the measurement techniques that are required to be applied under this standard. Furthermore, we highlight to the Board that we do not consider Example 17 to be helpful to preparers in implementing the measurement requirements. This example illustrates the application of the mathematical model, but does not provide any relevant implementation guidance on the important aspects of the model, i.e., the practicalities of determining the cash flows and the associated probabilities.

The Board has a stated objective of improving comparability between standards and sets out in the Basis for Conclusions how the Standard has been further brought into line with the requirements of IAS 39. On a conceptual level, we understand the Board's attempts to introduce consistency; however, here we can see a number of areas where the proposal is actually diverging from the requirements of IAS 39. Given the significant (and increased) subjectivity of this measurement approach, it seems that the proposal is inconsistent with the strict requirements under IAS 39 to fair value financial instruments (and therefore recognize gains and losses) using quoted market prices or, at the very least, available observable market data in order to reduce the subjectivity of fair value measurement. Indeed, IAS 39 does not permit certain financial instruments such as private equity investments to be fair valued and yet this proposal would require entities to "fair value" such subjective items as potential litigation.

We also note that the measurement model in the proposal (and particularly the statement that the 'most likely outcome is not necessarily consistent with the Standard's measurement approach') seems to be at odds with the impairment model in IAS 39 for financial assets. The impairment model requires entities to measure identified impairments based on objective evidence (i.e., observable data) that an impairment event has occurred. Coupled with this higher recognition threshold, the impairment model focuses on expected cash flows in measuring the charge as opposed to the full probability weighted cash flow approach set out in this proposal for non-financial liabilities. We do not believe that this inconsistency between the models is appropriate, given the higher level of subjectivity inherent in the measurement of non-financial liabilities.

In order to implement this approach, reporting entities will be required to capture, monitor and update large volumes of data on possible outcomes and associated probabilities of non-financial liabilities, some of which will have to be collected from external sources such as legal advisers. The methodology also drives the need for sophisticated valuation techniques and models to which a number of non-financial institutions may not have ready access. Even if this can be achieved operationally, it is likely to result in costs that many entities will find prohibitive. In our view, this proposal does not pass the 'cost versus benefit' test set out in the Framework, as we believe that the proposed recognition of highly subjective fair value gains and losses in the income statement will not provide users with more useful information than the disclosures required by the current provisions of IAS 37.

Not withstanding the cost and practical implications set out above we can see that this approach does have some theoretical merit for pools of small, homogeneous items such as product warranties. However, we have noted a number of serious limitations to the approach, which are particularly relevant for large single items such as legal disputes. Therefore, we do not consider that the benefit derived from having a single model for all non-financial liabilities is sufficient to justify the adoption of the proposed approach.
Question 7 – Reimbursements

The Exposure Draft proposes that when an entity has a right to reimbursement for some or all of the economic benefits that will be required to settle a non-financial liability, it recognizes the reimbursement right as an asset if the reimbursement right can be measured reliably (see paragraph 46).

Do you agree with the proposed amendment to the recognition requirements for reimbursements? If not, why not? What recognition requirements would you propose and why?

Response

We agree with the Board's view that an entity should recognize its right to an unconditional reimbursement if it has recognized an underlying non-financial liability, and we recognize that the inclusion of the 'reliably measurable' criterion introduces a sufficiently high recognition threshold. However, we refer the Board back to our overall concerns with the underlying recognition model and application of the probability criterion.

Question 8 – Onerous contracts

The Exposure Draft proposes that if a contract will become onerous as a result of an entity's own action, the liability should not be recognized until the entity takes that action. Hence, in the case of a property held under an operating lease that becomes onerous as a result of the entity's actions (for example, as a result of a restructuring) the liability is recognized when the entity ceases to use the property (see paragraphs 55 and 57). In addition, the Exposure Draft proposes that, if the onerous contract is an operating lease, the unavoidable cost of the contract is the remaining lease commitment reduced by the estimated sublease rentals that the entity could reasonably obtain, regardless of whether the entity intends to enter into a sublease (see paragraph 58).

a) Do you agree with the proposed amendment that a liability for a contract that becomes onerous as a result of the entity's own actions should be recognized only when the entity has taken that action? If not, when should it be recognized and why?

b) Do you agree with the additional guidance for clarifying the measurement of a liability for an onerous operating lease? If not, why not? How would you measure the liability?

c) If you do not agree, would you be prepared to accept the amendments to achieve convergence?

Response to (a)

We do not believe that the proposed model for accounting for onerous contracts within the proposal is sufficiently clear in the ED. We understand that the proposal clearly divides onerous contracts into those that become onerous as a result of items outside the entity's control and those that become onerous as a result of the entity's own actions. We do not understand how the guidance on contracts that become onerous as a result of items outside the entity's control should be applied. Consider a lease payment or a take or pay contract where the market rate for the rentals/underlying declines below the rate in the contract; it is not clear when the unavoidable costs exceed the economic benefits expected to be received. Taking the
example to an extreme, if a manufacturer has a single leased factory for which it is paying above market rent, should it recognize a non-financial liability in periods when the company (i.e., that factory) records a loss and then reverse it for periods when the company realizes a profit?

In cases where a contract becomes onerous because of the entity's own actions, we support the Board's overall intention effectively to increase the recognition threshold, so that entities cannot recognize liabilities for onerous contracts purely as a result of management intention. However, in our opinion, the Board needs to clarify the interaction between an entity's own actions and market factors for determining when a contract is onerous. For example, the ED would require an entity to record a liability at the date it vacates leased premises (at that point, the economic benefit to the entity would be less than the required future lease payments). However, we would expect in many circumstances that the lease contract had become onerous prior to that date due to other factors outside the entity's control. Should the entity record a liability if market rentals for leases have declined and the entity expects to vacate the leased premises, or should the entity wait to record any liability until it vacates the premises? The guidance in the ED is not clear and could result in inconsistent application in practice.

Response to (b)

See response to (a).

Response to (c)

See response to (a).

Question 9 – Restructuring provisions

The Exposure Draft proposes that non-financial liabilities for costs associated with a restructuring should be recognized on the same basis as if they arose independently of a restructuring, namely when the entity has a liability for those costs (see paragraphs 61 and 62).

The Exposure Draft proposes guidance (or provides cross-references to other Standards) for applying this principle to two types of costs that are often associated with a restructuring: termination benefits and contract termination costs (see paragraphs 63 and 64).

a) Do you agree that a liability for each cost associated with a restructuring should be recognized when the entity has a liability for that cost, in contrast to the current approach of recognizing at a specified point a single liability for all of the costs associated with the restructuring? If not, why not?

b) Is the guidance for applying the Standard's principles to costs associated with a restructuring appropriate? If not, why not? Is it sufficient? If not, what other guidance should be added?

Response to (a)

We agree with the Board's proposals with respect to restructuring costs in isolation. In our view this proposal results in an improved model for the recognition of restructuring costs as it replaces the previous 'binary' recognition of such costs on a subjective basis, and replaces it with a progressive recognition approach when different elements of the restructuring costs have
been incurred. However, we also note that this part of the proposal seems to be another 'carve out' from the overall recognition model as restructuring liabilities are only recognized when the individual liabilities have been contractually incurred. In our view, this approach is inconsistent with the requirement for constructive obligations to be recognized when there is a 'valid expectation that can be reasonably relied upon' as a result of past practice or sufficiently specific current statement.

Response to (b)

Notwithstanding our response to (a) above, current IAS 37 provides a user of the financial statements with a significant amount of useful information on the expected costs that will result from a restructuring program, thus helping the user to determine the profitability of an entity post restructuring. We urge the Board to consider the disclosure requirements of IAS 10 and to ensure that the disclosure requirements of an amended IAS 37 do not reduce the amount of information provided to users of the financial statements.

We also believe that the guidance around when an entity "ceases to use" the rights conveyed by an asset needs further clarification. We can envisage scenarios where manufacturers may 'mothball' certain facilities due to a temporary lack of demand or a transition into a new market that is expected to expand, as opposed to the permanent abandonment scenario outlined in the proposal. In our view the proposal does not address this point and so it is, as a result, unclear whether a liability should be recognized.