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Brasília, Distrito Federal - Brazil
www.cpc.org.br

May 21, 2010

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

RE: Exposure Draft on Measurement of Liabilities in IAS 37.

Dear Sir/Madam,

The "Comitê de Pronunciamentos Contábeis" - CPC[1] welcomes the opportunity to comment on the Exposure Draft named Measurement of Liabilities in IAS 37.

We are a standard-setting body engaged in the study, development and issuance of accounting standards, interpretations and guidances for Brazilian companies. Our members are nominated by the following entities:

a) the São Paulo Stock Exchange;
b) the Federal Accounting Council;
c) the Brazilian Association of Listed Companies;
d) the Brazilian Institute of Independent Auditors;
e) the Research Institute of Accounting, Actuarial and Financial Foundation; and
f) the National Association of Capital Market Investment Professionals and Analysts.

This response summarizes the views of our members, which may be supported by the opinions of external parties, sent to us for analysis and to enhance the discussion on the subject matter. We have also made efforts to encourage other external parties to send comments directly to the IASB.

We acknowledge that the following steps have been taken within the project in order to revise IAS 37:

1. In June 2005 the Board published an Exposure Draft of the proposed amendments to IAS 37 and IAS 19. The proposals related to IAS 37 would change the way liabilities covered by that standard are recognized and measured. Convergence toward US GAAP would also be obtained for certain accounting issues;

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[1] Brazilian Accounting Standards Board

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2. In January 2010 the Board published an Exposure Draft named "Measurement of Liabilities in IAS 37", which contains proposals that would change the way liabilities are measured under IFRS; and
3. In February 2010 a "Working Draft" of the revised IAS 37 was published.

However, we would like to point out the fact that at the time the discussions first took place during 2005 many countries did not require or permit the use of IFRS, Brazil included. Five years later, we believe that the situation in terms of IFRS application has changed around the world, and that this new Working Draft incorporates many of the changes previously proposed for topics currently covered by IAS 37, including:

a) definition of constructive obligations;
b) accounting for onerous contracts;
c) accounting for restructuring costs;
d) recognition of liabilities; and
e) measurement of liabilities.

Since the IASB is not asking for comments on some of the changes proposed above, we question if the approach taken by the Board under this project was the most appropriate one. We strongly suggest that the Board reconsider this approach and re-open the Working Draft for public consultation on all the proposals based on the aforementioned facts.

Nevertheless, we believe that some aspects of the Working Draft are worth mentioning:

(i) Recognition criteria: availability of information

The Working Draft of IAS 37 defines a liability in Paragraph 8 as "a present obligation … arising from past events, the settlement of which is expected to result in an outflow of resources embodying economic benefits."

Paragraph 14 of the Working Draft requires that "about uncertainty the management of the entity shall judge whether an obligation exists, taking into account all available evidence and giving more weight to the evidence that is more persuasive", and concludes by stating "if other sources of evidence exist, management shall also consider the evidence from those other sources". In the case of legal disputes, certain situations may be unclear as to whether the entity has an obligation.

However, we believe it would be appropriate to include an explanation such as the one proposed for a new IFRS on fair value measurement (Exposure Draft 2009/5), under which "fair value measurement shall assume that the transaction to sell the asset or transfer the liability takes place in the most advantageous market to which the entity has access" but "an entity need not undertake an exhaustive search of all possible markets to identify the most advantageous market".

Also, according to Paragraph A12 of IAS 36:

> "The application of an expected cash flow approach is subject to a cost-benefit constraint. In some cases, an entity may have access to extensive data and may be able to develop many cash flow scenarios. In other cases, an entity may not be able to develop more than general statements about the variability of cash flows without incurring substantial cost. The entity needs to balance the cost of obtaining additional information against the additional reliability that information will bring to the measurement."

(ii) Recognition criteria: use of thresholds

We suggest that the Board clarify how the likelihoods involved in a legal case should be considered when determining whether a present obligation exists regarding lawsuits, since this will be one of the most important factors in the recognition of liabilities. Also, the use of thresholds in the determination as to whether or not an obligation exists would avoid the recognition of certain liabilities when there is a low probability of a legal case ending up in an unfavorable decision.

The more-likely-than-not threshold could be a basis for such criteria and used for recognition of liabilities surrounded by great incertitude. Under US GAAP, for instance, ASC 740 requires an entity to "initially recognize the financial statement effects of a tax position when it is more likely than not, based on the technical merits, that the position will be sustained upon examination."

(iii) Recognition criteria: reliability of measurement

Eliminating the requirement that an outflow of resources should be probable for a liability to be recognized would increase the reliance of preparers of financial statements and auditors on the remaining criteria. We have noticed that the Working Draft incorporates additional guidance to explain on which occasions an entity would have a present obligation. However, explanations on which occasions a liability could be reliably measured remain essentially the same as the ones proposed in IAS 37.

Therefore, we suggest the inclusion of additional guidance in order to help preparers of financial statements and auditors to reach a conclusion on whether or not a liability can be reliably measured. Under US GAAP for instance, Paragraph 8 of ASC 410.20.25 lists the circumstances under which asset retirement obligations could be reliably measured: (a) "the settlement date and method of settlement for the obligation have been specified by others"; or (b) "the information is available to reasonably estimate (1) the settlement date or the range of potential settlement dates, (2) the method of settlement or potential methods of settlement, and (3) the probabilities associated with the potential settlement dates and potential methods of settlement".

(iv) Transition

We believe that the Exposure Draft of 2010 should have presented transitional provisions and invited the interested parties to make comments on it.

Please see our detailed comments on the Board's questions in the Appendix to this letter.

If you have any questions about our comments, please contact our Board Member, Geraldo Toffanello (*geraldo.toffanello@gerdau.com.br).*

Yours sincerely,

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Appendix - Consultation Questions

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?

Comments on Question 1

The expected value

The Exposure Draft proposes that an entity should measure a liability at the lowest of: (a) the present value of the resources required to fulfill the obligation; (b) the amount that the entity would have to pay to cancel the obligation; and (c) the amount that the entity would have to pay to transfer the obligation to a third party. More specifically, when an entity calculates the present value of an obligation then it should use the expected value approach.

Past criticisms made on the use of the expected value approach for situations involving few outcomes are well known. Paragraph A13 of IAS 36, in line with Paragraph 52 of the FASB Concept Statement 7 under US GAAP, for example, explains that:

"Some maintain that expected cash flow techniques are inappropriate for measuring a single item or an item with a limited number of possible outcomes. They offer an example of an asset with two possible outcomes: a 90 per cent probability that the cash flow will be CU10 and a 10 per cent probability that the cash flow will be CU1,000. They observe that the expected cash flow in that example is CU109 and criticise that result as not representing either of the amounts that may ultimately be paid."

Paragraph 53 of Concept Statement No. 7 adds more information to the discussion by stating that the measurement objective of an expected cash flow technique would be the fair value of an asset or a liability. Therefore, in the abovementioned example fair value would be closer to CU109 than to either CU1,000 or CU10.

At this point we would like to emphasize that the Exposure Draft does not specify what sort of measurement technique should be used for estimating an amount for which a

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liability could be canceled or transferred, when uncertainties exist. We are assuming that the expected value should be calculated for any situation and in this case it seems to us that the amount payable for transferring a liability would equal its fair value, under the definition proposed by the Board in the Exposure Draft 2009/5.

Based on the comments on the excerpts that we have made so far, we conclude that the expected-value technique would be appropriate whenever the measurement objective is to estimate the fair value of a transferable liability, even in situations with few possible outcomes . However, when an entity needs to estimate the cost it will incur to fulfill its obligation or to cancel a liability we do not agree on the point that the expected value would be the best alternative for situations with few outcomes (amounts such as the CU109, presented in the example above, would have little use for analysts and investment professionals in Brazil).

In the case of tax lawsuits, for instance, it is unusual for Brazilian entities to have the possibility to negotiate with tax authorities the settlement of a dispute out of the court, except in very limited circumstances in which the Federal Government launches tax amnesty programs. Therefore, in most cases, there would be only two possible outcomes for tax disputes: the payment of the full amount of the tax under dispute or nothing. Cancellation or transfer of such obligations would not be possible. Based on the current version of IAS 37, Brazilian entities have measured the liabilities related to these legal obligations based on the most likely outcome, which in practice, is the full amount of the present legal obligation (based on the existing enacted law), plus interest and fines. Such practice has been consistently applied, resulting in comparable financial positions between different entities.

We believe that the most appropriate measurement criterion for tax disputes would be the most likely amount of an outflow of resources, and consequently, we suggest that the Board reconsider its approach regarding the use of the expected value as a criterion. We would like to suggest the following general approach for measuring liabilities under IFRS: (a) the amount for which a liability could be transferred should be measured at its fair value; and (b) the amount for which a liability could be fulfilled or canceled would depend on how many outcomes are available and if the liability can be transferred or canceled. For situations with few outcomes available and without the possibility of transferring or canceling, the most-likely-outcome approach should be used. For all other situations the expected value approach should be used.

The following decision tree illustrates our suggestion:

Is cancelation or transference possible? — Yes — Lower of:

- Expected value of the cancelation price
- Transference price (Fair Value)
- Expected present value of the resources required to fulfil the obligation on an entity basis

No

Few outcomes? — Yes — Most likely outcome of the present value of the resources required to fulfil the obligation on an entity basis

No

Expected present value of the resources required to fulfil the obligation on an entity basis

If our suggestion is not accepted, we believe that there should be more guidance on the determination of an "unbiased estimate of probability of each outcome" as described in Paragraph B3 (d) of the Exposure Draft. Preparers of financial statements and auditors may face a significant degree of subjectivity in the process of setting up the percentage of probability that an entity needs in order to apply for each of the outcomes. Additionally, the lack of a consistent application among entities may lead to the measurement of lower liabilities in some entities and higher liabilities in other entities for the same type of taxes under dispute.

Risk Adjustment

Generally, tax disputes in Brazil remain pending decision for a relative long period of time. Some of them may be decades open under dispute leaving preparers of financial statements with a low level of reliable estimates on the timing of cash outflows. It is unclear whether this issue would be resolved by the provisions of Paragraphs B15 to B17.

Paragraph B15 requires that a risk adjustment be applied to the expected present value if the entity would pay such an amount to be relieved of this risk. On Page 37 of the Exposure Draft the example illustrates an amount of 5%, but with little guidance as to under which circumstances an entity might have to pay this additional amount, how this amount is calculated or how management might determine such an adjustment. It is not clear how (or whether) these risks might have already been included when determining the probabilities used for determining the expected value or whether the risks are being double-counted. Applying such a risk adjustment may be ascribing a degree of precision to what is ultimately an accounting estimate. We suggest that the requirement for an additional risk adjustment be removed; if not, that guidance on how such a risk adjustment might be calculated be provided.

Non-performance risk

We are aware that during the Board meeting held in January 2010 the IASB and the FASB tentatively decided that the fair value of a non-financial liability should include the effect of non-performance risk. According to the Agenda Paper prepared by the staff for that meeting, non-performance risk of non-financial liabilities is explained as follows:

"For a non-financial liability, non-performance risk relates to the risk the entity will not be able to perform. For a decommissioning liability or asset retirement obligation, this is the risk that the entity will not do what it has promised (e.g. legally or contractually) it will do at the end of the operations. Part of this risk relates to the entity's ability and willingness to perform the work needing to be done. Part relates to the entity's ability to finance the 'clean up' operations."

However, it is not clear in the Exposure Draft "Measurement of Liabilities in IAS 37" whether non-performance risk should be considered when measuring liabilities currently under the scope of IAS 37. How non-performance risk should be considered in measuring liabilities also concerns us since it could affect the comparability of financial statements in Brazil. We believe that any requirement on this matter should be accompanied by a sufficient amount of guidance.

Use of legal precedents

Whereas it is understood that legal claims may give rise to uncertainty as to the existence of a present obligation, the Working Draft does not specifically clarify whether legal precedent in similar cases should be viewed as a factor to be considered. Paragraph 14 includes a number of examples of matters to consider when determining whether a liability exists, but is not specific when dealing with such an important issue within the scope of the standard.

Legal precedent is extremely important in determining the likely outcome of a lawsuit as it reflects the most recent position of the courts. In countries in which the legal system is governed by Common Law, legal precedent is generally considered as an important source of law when the legal counsel determines its views. In countries in which the legal system is governed by Civil Law (based on the Napoleonic Code), such as Brazil, legal arguments tend to focus on interpreting the text of the law rather than basing itself on legal precedents. To ensure that positions taken are based on the most current interpretation of the law, we strongly encourage legal precedent to be explicitly included in the accounting guidance.

Additionally, we suggest that the Board include a clarification in Sub-paragraph (b) of Paragraph 14, as follows:

(b) other entities' experience (including decisions taken by the courts) with similar items;

Question 2 – Obligations fulfilled by undertaking a service

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 would 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? If not, why not?

Comments on Question 2

We believe that the proposal is inconsistent with the general requirements to estimate the outflows of resources stated in Paragraph B5 of the Working Draft (emphasis added):

The estimates of the outflows of resources required to fulfil the obligation shall:
(a) incorporate, in an unbiased way, all available information about the amount, timing and probability of the relevant future outflows.
(b) be consistent with observable market prices, if such prices are available.

Additionally, the use of an estimate of an amount that the entity would charge another party at the future date to undertake the service may lead to discretionary amounts

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that are not supportable by observable inputs and, ultimately, open to manipulation. We also disagree on the statement that there is a market for most types of services. That would be the case in more mature markets, but entities in Brazil would face difficulties to use market inputs for certain types of services. Therefore, we strongly recommend that the Board reconsider the proposed amendment requiring an entity to estimate a margin for the service when there is no market available, by removing the requirement for a profit margin to be included in the measurement of the liability when the entity intends to undertake the work itself. Alternatively, provide guidance on how an entity should determine what profit margin should be included when there is no market for the particular service.

We also believe that the requirements of Paragraph B8 of Appendix B are inconsistent with the requirements of Paragraphs 36A and 36B of the Exposure Draft since they do not represent the amount an entity would rationally pay but rather the amount that could be measured if there was a market for such service. Assuming that the transference price of an obligation equals its fair value and in accordance with the general requirements proposed, an entity should measure a service obligation at the lowest of: (a) its cancelation price; (b) its transference price, which could be equivalent to the present value of the resources required to fulfill the obligation, calculated on a market basis; or (c) the present value of the resources required to fulfill the obligation, calculated on an entity basis.

Question 3 – Exception for onerous sales and insurance contracts

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 and why?

Comments on Question 3

In general we agree on the limited exception proposed in Paragraph B9.