Australian Government

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Sir David Tweedie
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Dear David

Exposure Draft ED/2010/1 *Measurement of Liabilities in IAS 37*
(Limited re-exposure of proposed amendment to IAS 37)

The Australian Accounting Standards Board (AASB) is pleased to submit its comments on Exposure Draft ED/2010/1 *Measurement of Liabilities in IAS 37.* In formulating these comments, the AASB sought and considered the views of Australian constituents. The comment letters received are published on the AASB's website.

Aspects of the ED supported by the AASB

The AASB supports the IASB's objective of clarifying the measurement requirements in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, which presently are expressed in a manner intended to provide latitude in interpretation (fair value or value in use). It recommends that, to achieve this:

(a) high-level measurement principles should be established for all classes of liabilities through the IASB-FASB Conceptual Framework project; and

(b) the requirements for the measurement of liabilities presently within the scope of IAS 37 (hereinafter, 'provisions') should not be amended before that is achieved.

However, if the IASB proceeds with amending the measurement requirements presently in IAS 37, the AASB would support measuring provisions at the amount proposed in paragraph 36B of the ED. The AASB agrees with the proposed policy of measuring provisions according to the least costly mode of settlement. However, the AASB considers that some of the proposed supporting guidance for paragraphs 36A and 36B of the ED is inconsistent with those key paragraphs (see comments on inconsistencies below).

Actual cancellation and transfer prices

The AASB supports the proposal in paragraph 36C of the ED that cancellation or transfer prices should not be used to measure provisions if the entity is unable to cancel or transfer its obligations. The AASB considers this is preferable to using prices in hypothetical transactions, because it reflects more faithfully that entry and exit markets for an obligation are different (as opposed to assuming away the difference, as occurs in the IASB's *Fair Value Measurement* ED) and takes into account the particular circumstances of the reporting entity.

Additional guidance provided

The AASB considers it useful that guidance has been provided on using expected present values to measure provisions and to clarify that adjusting the discount rate of a liability for risk typically involves using a lower rate than the risk-free rate.

The AASB's support for guidance on applying present value techniques is consistent with its proposal in its comment letter on IASB Exposure Draft ED/2009/10 *Discount Rate for Employee Benefits (Proposed amendments to IAS 19)* to have separate and more comprehensive guidance on discounting. The AASB repeats that call.

Exception for onerous sales and insurance contracts

The AASB supports the proposed limited exception from the general measurement requirements, in respect of onerous contracts arising from transactions within the scope of IAS 18 *Revenue* and IFRS 4 *Insurance Contracts*, until high-level measurement principles for all liabilities are developed through the IASB-FASB Conceptual Framework project.

Aspects of the ED not supported by the AASB

Despite supporting paragraph 36B of the ED, on balance, the AASB does not support the ED's proposals. Its reasons are set out below.

Proposals would require an unacknowledged significant change in practice

The stated intention for issuing the ED is to clarify the measurement requirements in IAS 37, rather than to change the main features of those requirements. The AASB is concerned that the ED's proposals would require a significant change in practice for many entities when measuring provisions, and therefore would go beyond clarifying the measurement requirements in IAS 37. Because the significance of the proposed change is not acknowledged by the ED, the AASB considers that the due process for the change is inadequate.

Relevance of the measures for assessing the entity's future cash flows

The ED proposes that estimates of resources required to fulfil an obligation should be consistent with observable market prices, if such prices are available (paragraph B5(b)). Such measures would provide less useful information to users for assessing the entity's future cash

flows than would a measure that directly reflects the risk-adjusted future cash flows likely to be incurred in fulfilling the obligation.

Lack of clear unifying principles

The AASB is concerned that the ED's proposals emphasise measurement techniques to be applied without specifying measurement principles (based on clear measurement attributes) for provisions. This lack of clear unifying principles is reflected in the ED's proposals to measure some provisions at the liability equivalent of value in use, whilst applying a methodology for calculating value in use that has some features of a fair value measurement. The ED proposes that other provisions be measured at their exit prices. Thus, the ED proposes adopting aspects of fair value in the measurement of all provisions, either explicitly or implicitly, but without specifying fair value as the measurement basis or wholly conforming to the concept of fair value. The AASB does not support the use of methods that are not consistent with known measurement attributes. Such methods do not convey clear meanings.

The AASB notes that the ED proposes adding to the diversity of measurement requirements for different classes of liabilities. This would appear to result from the absence of enunciated measurement principles for provisions.

Inconsistencies

The AASB is concerned that the ED includes various apparent inconsistencies.

The proposed guidance on measuring obligations fulfilled by undertaking a service is inconsistent with key paragraphs 36A and 36B of the ED, and is not supported by the AASB. Paragraph 36B(a) identifies the liability equivalent of value in use as one of the possible measures of a provision. However, the ED proposes that, in measuring obligations fulfilled by undertaking a service, 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. A contractor's price would reflect the contractor's expectations regarding risk-adjusted future cash outflows to fulfil the obligation, which may differ significantly from the risk-adjusted future cash outflows likely to be incurred by the entity in fulfilling the obligation. In addition, the supporting guidance on determining the amount in paragraph 36B(a) is inconsistent with a value in use measure, because it reflects important elements of a fair value measurement (such as the requirement to use observable market prices, if available).

Other apparent inconsistencies within the ED are set out in Appendix A to the attached submission.

Insufficient guidance

The AASB is concerned that the ED provides insufficient guidance on some aspects. The most important of these omissions are that:

(a) in relation to its proposed requirement that the estimates of the outflows of resources required to fulfil an obligation "shall be consistent with observable market prices, if such prices are available" (paragraph B5(b)), the ED does not specify the nature or characteristics of the market in which prices should be observed. Therefore, the extent to which market prices should be preferred to management estimates of outflows required to fulfil an obligation is unclear;

(b) the ED does not specify whether the amount the entity would have to pay to transfer the obligation to a third party (under paragraph 36B(c)) relates to a 'transfer with recourse'. Whether a transfer is assumed to occur with, or without, recourse to the reporting entity can significantly affect the measured amount of the obligation and the methodology used to measure that amount; and

(c) the nature of the risk adjustment that measures the amount, if any, that the entity would rationally pay to be relieved of the risk that the actual outflows of resources might ultimately differ from those expected needs to be clarified. For example, it is unclear whether:

    (i) the risk adjustment is the amount that adjusts the entity-specific cost of settlement to an immediate settlement amount or fair value of the liability; and

    (ii) the risk adjustment includes an element for the entity's own credit risk.

In the latter case, it is not clear how the treatment of provisions will relate to the measurement requirements for financial liabilities.

Other aspects on which additional guidance is needed are identified on pages 14 – 18 of the attached submission.

AASB's recommendations

Based on these concerns, the AASB recommends that:

(a) measurement principles be established for all provisions, and these should be consistent with those for other classes of liabilities, such as financial liabilities, liabilities to customers presently accounted for under IAS 18, liabilities under insurance contracts and lease liabilities;

(b) if the IASB proceeds with amending the measurement requirements presently in IAS 37, the AASB would support measuring liabilities presently within the scope of IAS 37 at the amount proposed in paragraph 36B of the ED, namely, at the lowest of:

    (i) the present value of the resources required to fulfil the obligation;

    (ii) the amount that the entity would have to pay to cancel the obligation; and

    (iii) the amount that the entity would have to pay to transfer the obligation to a third party; and

(c) in contrast to the proposed guidance in the ED, the present value of the resources required to fulfil the obligation should be an entity-specific measure. The estimated cash flows should be those for the entity to fulfil the obligation, reflecting the likely mode of settlement of the obligation (using contractors, internal resources or a combination of both). Similarly, the risk adjustment to the expected cash flows incorporated in the present value of the resources required to fulfil the obligation should not adjust the entity-specific cost of settlement to an immediate settlement amount or some element of the fair value of the liability.

Concerns remaining in respect of the proposals in the 2005 Exposure Draft

The AASB is concerned about two aspects of the IASB's 2005 ED (which proposed amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and IAS 19 *Employee Benefits*) that continue to be reflected in the Working Draft IFRS *Liabilities* placed on the IASB web site on 19 February 2010. These aspects are insufficient clarification of:

(a) the potential scope of stand-ready obligations, as described in paragraph 19 of the Working Draft IFRS; and

(b) the significance of the distinction between conditional and unconditional obligations for the identification and measurement of provisions.

Although IASB Exposure Draft ED/2010/1 invites comment only on measurement aspects of the IFRS that would replace IAS 37, the AASB notes these concerns because it considers it important that they be addressed in finalising the new IFRS. These concerns are explained in Appendix C to the attached submission.

The AASB's specific comments on the questions in the ED are set out in the attached submission. The AASB's editorial comments on the ED are set out in Appendix D to the submission.

If you have queries regarding any matters in this submission, please contact me or Mischa Ginns (mginns@aasb.gov.au).

Yours sincerely

Kevin M. Stevenson
Chairman

AASB's Specific Comments on IASB Exposure Draft ED/2010/1 *Measurement of Liabilities in IAS 37*

1. The AASB's views on the questions in the ED's Invitation to Comment are 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?

Overall comment

2. The AASB does not support the ED's proposals. It is concerned that:
   - (a) the proposed measurement requirements for provisions (based on ohservable market prices) would provide less useful information to users for assessing the entity's future cash flows than would a measure that directly reflects the risk-adjusted future cash flows likely to be incurred in fulfilling the obligations;
   - (b) the ED's proposals emphasise measurement techniques to be applied without specifying clear measurement attributes or a measurement model for provisions; and
   - (c) the ED includes inconsistencies and provides insufficient guidance on some aspects.

3. The AASB notes that the ED proposes adding to the diversity of measurement requirements for different classes of liabilities. The AASB recommends developing high-level measurement principles for all classes of liabilities before amending the measurement requirements for provisions presently set out in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

4. These and other concerns of the AASB, and the AASB's recommendations, are explained below.

Clarification or substantial change?

Summary: The AASB considers that the ED's proposals would require a significant change in practice for many entities when measuring provisions, and therefore go beyond clarifying the measurement requirements in IAS 37.

5. The stated intention of the ED is to clarify the application of the measurement requirements in IAS 37, rather than to change the main features of those requirements. However, in substance, the ED proposes changing the main features of those requirements, due to the latitude in interpretation (fair value or value in use) provided by the existing measurement guidance in IAS 37 and the way the guidance has been applied in practice. Thus, the ED proposes a significant narrowing of the measurement methodologies acceptable for measuring provisions, without acknowledging this. This is explained below.

Current interpretations of the existing measurement guidance in IAS 37

6. In describing its proposed changes as a 'clarification' of the measurement requirements in IAS 37, the ED implies the revised methodology specified in paragraph 36B is the only methodology to validly use under IAS 37. However:

   (a) Presently, it is widespread practice for entities to measure provisions at the best estimate of the cost to them to fulfil the present obligation. Entities do this on the basis of the following text in IAS 37:

      > "The amount recognised as a provision shall be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period." (IAS 37, paragraph 36); and
      >
      > "The best estimate of the expenditure required to settle the present obligation is the amount that an entity would rationally pay to settle the obligation at the end of the reporting period or to transfer it to a third party at that time. ..." (IAS 37, paragraph 37).

   (b) They argue that:

      (i) in many (if not most) cases, an entity would rationally pay no more than the entity's own cost to fulfil the present obligation;

      (ii) 'the amount that an entity would rationally pay to settle the obligation at the end of the reporting period' (IAS 37, paragraph 37) refers to the obligation that exists at the end of the reporting period and the amount the entity would rationally pay to settle it. It does not refer to 'the amount that an entity would rationally pay at the end of the reporting period to settle the obligation' (i.e., an immediate settlement amount); and

      (iii) if, instead, an immediate settlement amount were intended, IAS 37 would have used those words to describe the measurement attribute (rather than the more complex formulation in paragraph 37), and the amounts proposed in paragraph 36B of the current ED would be restricted to those in limbs (b) and (c) thereof.

   (c) In contrast to (b), the ED implies the commonplace interpretation of IAS 37 in (a) is inconsistent with IAS 37. The ED says:

"The Board considered whether the outflows of resources required to fulfil (an obligation that is fulfilled by undertaking an activity or service) would be:

(a) the expected costs of undertaking the service; or

(b) the value of the service, i.e. the amount that an entity would rationally pay a contractor to undertake the service on its behalf." (Basis for Conclusions, paragraph BC19)

"the overall measurement objective in IAS 37 is to estimate the amount the entity would rationally pay to be relieved of an obligation. If an entity has an obligation to undertake a service in the future, the amount that it would rationally pay to avoid that obligation would reflect the value—not just the cost—of the resources that it will have to sacrifice to fulfil the obligation." (Basis for Conclusions, paragraph BC21(d))

Lack of clear unifying principles

Summary: The AASB is concerned that the ED proposes using a combination of exit prices and value in use to measure provisions, but its proposed methodology for calculating value in use has some features of a fair value measurement. Thus, the ED adopts aspects of fair value in the measurement of all provisions, either explicitly or implicitly, but without specifying fair value as the measurement basis or wholly conforming to the concept of fair value.

7. Paragraph 36B of the ED clarifies that the amount measured under the proposed key paragraph 36A is, effectively, the lower of:

   (a) the 'value in use' equivalent for the provision[1] (covered by paragraph 36B(a)); and

   (b) the immediate settlement amount, either from cancellation by the counterparty (paragraph 36B(b)) or from transferring the obligation to a third party (paragraph 36B(c)).

8. Thus, the amount described in paragraph 36B is the liability equivalent of the recoverable amount of an asset as defined in IAS 36 *Impairment of Assets*.

9. This assessment is based on paragraph 36B when read in isolation. However, the supporting guidance on determining the amount in paragraph 36B(a) contradicts that assessment because that amount has important elements of a fair value measurement rather than of value in use. The apparent contradictions are discussed below.

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1 Paragraph 36B(a) does not use the term 'value in use'. However, this meaning is discerned from paragraph BC10 of the Basis for Conclusions and, particularly, from IASB Staff Paper 11B for the November 2009 IASB Meeting (paragraph 7(c)).

10. The guidance on limb (a) of the three measures in paragraph 36B of the ED (the 'value in use' equivalent, i.e., "the present value of the resources required to fulfil the obligation") requires a market-based measure to be used. This is manifested in the ED's following proposed requirements, with which the AASB disagrees:

    (a) the estimates of resources required to fulfil an obligation shall be consistent with observable market prices, if such prices are available (paragraph B5(b)); and

    (b) consistent with paragraph B5(b) of the ED, for obligations fulfilled by undertaking a service, the relevant outflows for such obligations are the amounts that an entity would rationally pay a contractor at the future date to undertake the service on its behalf (paragraph B8).

    These proposed requirements are discussed below.

11. Regarding both (a) and (b) in paragraph 10, the requirement in paragraph B5(b) of the ED for estimates of resources required to fulfil an obligation to be consistent with observable market prices indicates that observable market prices, when available, are considered more relevant and reliable[2] than entity-specific estimates of those resource flows. However, the resources required to fulfil an obligation (such as an asset retirement obligation) will often depend on entity-specific circumstances. Therefore, an entity's management may possess superior knowledge of the future cash outflows to settle the obligation than would be possessed by other market participants. The proposal in paragraph B5(b) implies greater emphasis on the objectivity provided by observable market prices than the relevance of those prices for assessing the entity's likely future cash flows. However:

    (a) the objectivity provided by observable market prices depends on the whether the prices are observed in an active market. If a market is not an 'active market', as defined in IAS 38 *Intangible Assets*, an observable market price would not represent the consensus of a wide range of market participants (which is the main basis for the claimed objectivity of market prices[3]). See the comments in paragraphs 24 – 26 and 30 – 31 of this submission regarding the need to clarify the meaning of an 'observable market price'; and

    (b) this proposal is also inconsistent with the concept of value in use adopted in IAS 36, which does not require observable market prices to be preferred to management's best estimate of future cash flows arising from an asset.

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[2] 'Reliable' is used here to refer to a component of being 'representationally faithful'.

[3] Discussion Paper *Measurement Bases for Financial Accounting: Measurement on Initial Recognition*, prepared by the staff of the Canadian Accounting Standards Board and published by the IASB in November 2005, says "... the market value measurement objective has important qualities that make it superior to an entity-specific measurement, at least on initial recognition. Primary among these qualities is that competitive market forces work to resolve diverse expectations of various entities' managements to a single price that impartially reflects all publicly available information on any given measurement date." (paragraph 128)

12. Regarding the reliability of market prices (as a reason for the proposed requirement in paragraph B8 to use estimated contractor prices to measure obligations to undertake a service at a future date), it should be borne in mind that observed market prices are to be used as inputs to the estimated *future* contractor prices that are discounted to their present value. This is illustrated in the [draft] Illustrative Example on pages 35 – 37 of the ED. Because estimated future contractor prices are inherently less reliable than observed current market prices for an obligation, the reliability benefits of using contractor prices (in preference to entity-specific estimates of future cash outflows) are highly limited.

13. Regarding point (b) in paragraph 10, the price charged by a contractor includes a profit margin on the estimated costs to provide the service.[4] When using a contractor is not the most likely mode of settlement for a particular obligation, using a price that includes a profit margin to measure the present value of the resources required to fulfil the obligation would be inconsistent with the notion of the fulfilment value (the 'value in use' equivalent) of the liability. Refer to the AASB's comments on Question 2 for further comment on the use of contractor prices.

14. Paragraph BC21(d) states the amount an entity would rationally pay to avoid an obligation "would reflect the value—not just the cost—of the resources that it will have to sacrifice to fulfil the obligation". This seems to imply fulfilment value is measured by reference to the cost-based carrying amounts of resources the entity consumes in rendering the services that settle its obligation. However, fulfilment value should be determined by summing the amount of estimated cash outflows and the fair value of non-cash resources estimated to be consumed in rendering the service. Therefore, in contradiction to paragraph BC21(d), fulfilment value is a value, not a cost-based measure.

15. In effect, the ED proposes incorporating some features of a fair value measurement into the 'value in use' equivalent. This effectively involves a piecemeal shift toward the adoption of fair value to measure provisions without specifying fair value as the sole measurement attribute to be adopted. Such a change lacks transparency (because the ED does not identify the significance of the change), elevates techniques above principles (because the measurement proposals are set out as techniques to be applied without stating clear measurement attributes) and increases the range of fair value-type measures in IFRSs (because some items would be measured at fair value while others, such as provisions, are measured at amounts that incorporate important elements of a fair value measurement but differ from fair value in some respects). Some differences from fair value proposed in the ED are set out in Appendix B.

<u>Rationale for the ED's proposals</u>

16. The AASB has the following concerns about two aspects of paragraph BC10(b) of the Basis for Conclusions on the ED:

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[4] See paragraph B8(b) in relation to modelling a proxy for that price in the absence of a market for contracting out the provision of the service.

(a) The second sentence of paragraph BC10(b) notes that the measure determined under paragraph 36B captures value-maximising behaviour. However, the Basis for Conclusions does not explain why 'capturing value-maximising behaviour' in a measurement of a liability provides useful information to users of general purpose financial reports in making decisions about providing resources to the entity and in assessing whether the management and the governing board of that entity have made efficient or effective use of the resources provided. Although it agrees with paragraph 36B of the ED, the AASB thinks it is important to build a bridge between reflecting the rational behaviour of market participants in a measurement and meeting the objective of general purpose financial reporting; and

(b) The last two sentences of paragraph BC10(b) indicate that measuring a liability at the lowest amount payable to settle or otherwise be relieved of a liability is similar to measuring an impaired asset at the higher of value in use and fair value less costs to sell. In one important respect, this is an incomplete characterisation. In applying IAS 36, measurement at the higher of value in use and fair value less costs to sell (i.e., recoverable amount) occurs only if the asset is impaired. Otherwise, the asset is measured at cost (entry price) or revalued amount. In contrast, under the ED's proposal, measurement at the lowest amount payable to settle or otherwise be relieved of a liability would be required for all liabilities within the scope of the [proposed] new IFRS *Liabilities*. There is no scope to measure such liabilities at an entry price (such as a customer consideration amount). This difference in context should generally not matter in practice, because most liabilities incurred for a customer consideration amount belong within the scope of IAS 18 *Revenue*. However, there are exceptions, such as warranty obligations, which presently are measured under IAS 37 and some of which might be measured under the [proposed] new IFRS *Liabilities* rather than the future replacement IFRS for IAS 18. Accordingly, the AASB suggests clarifying the relationship between the measurement of assets under IAS 36 (measurement at recoverable amount is conditional on a trigger event occurring) and measurement of liabilities under the [proposed] new IFRS *Liabilities* (measurement at the liability equivalent of recoverable amount is not conditional on a trigger event occurring).

AASB's recommendations

17. The AASB recommends that measurement principles be established for all provisions, and these should be consistent with those for other classes of liabilities, such as financial liabilities, liabilities to customers presently accounted for under IAS 18, liabilities under insurance contracts and lease liabilities.

Presently, the measurement requirements in IFRSs for different classes of liabilities are inconsistent. For example:

(a) financial liabilities and lease liabilities under finance leases are measured initially at fair value (ignoring transaction costs for simplicity of comparison);

(b) liabilities to customers are measured at the related customer consideration amount (entry price) [and, in its Insurance Contracts project, the IASB is considering requiring a similar measurement basis on initial recognition for some pre-claims liabilities to insureds];

(c) post-employment benefit obligations are measured at the estimated cost of settlement (effectively a value in use equivalent) and discounted using a high-quality corporate bond rate; and

(d) provisions are presently measured at either a value in use equivalent or an exit price (where value in use is determined by discounting estimated cash flows using a rate reflecting risks specific to the liability).

By proposing that provisions be measured at the lower of a value in use equivalent and exit price (where value in use incorporates some, but not all, aspects of a fair value measurement), the ED would increase the diversity of measurement bases used for different liability classes.

18. The AASB proposes that high-level measurement principles be established for all classes of liabilities through the Conceptual Framework project, and that the requirements for the measurement of provisions under IFRSs should not be amended before that is achieved.

19. However, if the IASB proceeds with amending the measurement requirements presently in IAS 37, the AASB would support measuring liabilities presently within the scope of IAS 37 at the amount proposed in paragraph 36B of the ED, namely, at the lowest of:

    (a) the present value of the resources required to fulfil 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.

20. The AASB agrees with the concept of measuring such liabilities according to the least costly mode of settlement.

21. The AASB considers that the amount described in paragraph 19(a) should be an entity-specific measure, in contrast to the amounts described in paragraph 19(b) and paragraph 19(c). The estimated cash flows should be those for the entity to fulfil the obligation, reflecting the likely mode of settlement of the obligation (using contractors, internal resources or a combination of both).

22. Paragraph B8(b) of the ED proposes that, to measure the present value of the resources required to fulfil an obligation by undertaking a service, if there is not a market for the service, the entity should estimate the amount it would charge another party at the future date to undertake the service. That amount would include a profit margin on the entity's estimated costs to provide the service. As mentioned above, the AASB does not support adding an explicit profit margin[5] to the entity's expected cost of fulfilment when measuring provisions. Adding an explicit profit margin would not be consistent with the ED's proposed key measurement requirement that an entity should 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" (paragraph 36A), and would provide less relevant information to users of financial statements than a risk-adjusted expected cost, because the risk-adjusted expected cost reflects the entity's most likely future cash outflows when it is less than the cancellation price and transfer price for the present obligation.

Additional guidance needed

Need for examples of payments to counterparties [paragraph 36B(b)]

23. If the IASB proceeds with amending the measurement requirements in IAS 37, it would be useful to provide some examples of payments to counterparties in settlement of a provision. This is because provisions do not involve lenders (covered by IAS 39 *Financial Instruments: Recognition and Measurement*) or customers (covered by IAS 18 and, in the case of insureds, IFRS 4 *Insurance Contracts*), with the possible exception of customers to whom warranties are provided (the AASB understands that the relationship between IAS 18 and IAS 37 regarding warranty obligations will be reviewed in the Revenue Recognition project, and it would seem that at least some warranty obligations will be covered by the replacement Standard for IAS 18). In the case of provisions such as asset retirement obligations, there may not be an identifiable counterparty to the obligation. Counterparties would exist in the case of provisions arising from legal disputes. It is difficult to identify many other types of provisions involving counterparties.

Unclear meaning of 'observable market prices' for amounts measured under paragraph 36B(a) of the ED

24. In relation to its proposed requirement that the estimates of the outflows of resources required to fulfil an obligation "shall be consistent with observable market prices, if such prices are available" (paragraph B5(b)), the ED does not specify the nature or characteristics of the market in which prices should be observed. Therefore, the extent to which market prices should be preferred to management estimates of outflows required to fulfil an obligation is unclear.

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[5] When using a contractor is the most likely mode of settlement for a particular obligation, the fact that the contractor price implicitly incorporates a profit margin on the contractor's costs is of no concern to the AASB, because the price would represent the reporting entity's estimated cost of settlement.

25. Paragraph BC21(a) of the Basis for Conclusions[6] says "there is a market for most types of service. So, in most situations preparers of financial statements can measure the value of services by reference to observable market prices …". Based on these comments, it would appear that 'observable market prices' need not be prices observed in an 'active market' as defined in IAS 38. However, guidance should not be set out in a Basis for Conclusions.

26. Readers of the [proposed] IFRS *Liabilities* might consider they should refer to the guidance in the IFRS developed from Exposure Draft ED/2009/5 *Fair Value Measurement,* such as its guidance on the characteristics of 'market participants' (paragraph 13). However, although ED/2009/5 includes extensive guidance on observable market prices, including the markets in which they are observed, that guidance applies to fair value measurements. In the absence of an enunciated measurement objective for provisions, it is unclear how relevant that guidance may be in this context.

27. The lack of clarity mentioned in paragraph 24 is exacerbated by the apparently different threshold applied in paragraphs B8(a) and B8(b) of the ED (compared with the threshold applied in paragraph B5(b)). Paragraph B8 says that, to determine the amounts the entity would rationally pay a contractor at a future date to undertake a service on its behalf:

    (a) if there is a market for a service, the amount is the price that the entity estimates a contractor would charge at the future date to undertake the service on the entity's behalf (paragraph B8(a)); and

    (b) if there is not a market for a service, the entity estimates the amount it would charge another party at the future date to undertake the service (paragraph B8(b)).

28. Whereas paragraph B5(b) says estimates should be consistent with *observable* market prices, paragraph B8 bases its distinction between using contractor prices and the entity's own prices on whether there is *a market* for the service (a less restrictive test). It is unclear why different market evidence thresholds are used in paragraphs B5(b) and B8, respectively.

29. Regarding the application of paragraph B8, the AASB considers there is a market for most, if not all, services. This view is similar to the comment in paragraph BC21(a) that there is a market for most types of service. However, since an important distinction in measurement methodology is made in paragraph B8, it appears that paragraph B8 is premised on a narrower interpretation of a 'market for a service'. In other words, if markets for services almost always exist, why specify a different treatment in paragraph B8(b) for circumstances in which 'there is not a market for the service'?

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6 Paragraph BC22 indicates the IASB supports the arguments in paragraph BC21.

30. In view of the different guidance in different Standards/proposed Standards regarding the markets in which prices may be observed, the AASB considers the IASB should explain in the Basis for Conclusions on the forthcoming IFRS *Liabilities* why it chose the particular nature and characteristics of the market in which prices for provisions should be observed (or, if it decides not to add guidance, why it chooses not to specify the particular nature and characteristics of that market).

31. When the IASB considers the nature of additional guidance to provide on this issue, the AASB encourages it to bear in mind that requiring estimates to be consistent with observable market prices only when active markets exist would address concerns about the diversity of counterparty pricing in other types of market. The AASB observes that prices demanded by particular counterparties for assuming an entity's obligations depend not only on the nature of those obligations, but also on the counterparty's appetite for risk and the characteristics of the counterparty's existing portfolio of obligations (and, thus, on the extent to which assuming the reporting entity's obligations would diversify or concentrate risk). In markets with few market participants, prices demanded by particular counterparties for assuming an entity's obligations may differ considerably, giving rise to concerns about the reliability of a particular counterparty's price as a measure of the reporting entity's obligations. However, in an 'active market', as defined in IAS 38, counterparty prices would tend to be clustered around a measure of central tendency, yielding more reliable estimates of the reporting entity's obligations.

*Omission to specify whether transfers of obligations are assumed to be made with or without recourse to the reporting entity [paragraph 36B(c)]*

32. The ED does not specify whether the amount the entity would have to pay to transfer the obligation to a third party (under paragraph 36B(c)) relates to a 'transfer with recourse'. In a transfer of an obligation with recourse to the reporting entity (obligor), the obligee (the original party to which the reporting entity had a present obligation) retains a right of recourse to the reporting entity if the transferee of the obligation (contractor) fails to perform as promised. In the IASB's earlier work on its Revenue Recognition project, a transfer with recourse was analysed as follows:

    (a) the reporting entity transfers to a contractor the 'performance obligation' (the obligation to provide goods or services); while

    (b) the reporting entity retains a 'performance guarantee' (the obligation to stand ready to remedy any failure by the contractor to provide the promised goods or services).

33. In contrast, in a transfer without recourse, the obligee relinquishes all claims against the reporting entity, and thus has no recourse to the reporting entity if the contractor fails to perform as promised.

34. If the amount the entity would have to pay to transfer the obligation to a third party (under paragraph 36B(c) of the ED) may be interpreted to relate to a 'transfer with recourse', that transfer price may exclude the price of the reporting entity's

performance guarantee. The AASB would not support measuring a provision at an exit price that excludes the reporting entity's performance guarantee and thus does not measure the price of complete extinguishment of the liability. If an amount is purported to be, effectively, the exit price of a liability, it should faithfully represent that exit price by using the price for a transfer without recourse.

Need to clarify the components of risk, including whether own credit risk is taken into account

35. The ED says the estimated present value of the resources required to fulfil an obligation includes a risk adjustment that measures the amount, if any, that the entity would rationally pay to be relieved of the risk that the actual outflows of resources might ultimately differ from those expected (paragraphs B1(b) and, in particular, paragraphs B15 – B16). The AASB agrees with this proposed requirement.

36. However, the nature of the risk adjustment is unclear. A measure of the immediate settlement amount or fair value of the liability would incorporate this risk because the counterparty or transferee would demand compensation for assuming this risk. It is unclear whether the risk adjustment is the amount that adjusts the entity-specific cost of settlement to an immediate settlement amount or fair value of the liability. In view of the proposed requirements mentioned in paragraph 10 of this submission, it would be reasonable to conclude that this is the intended effect of the risk adjustment. The AASB would not support such an intended effect of the risk adjustment, because it supports using an entity-specific measure of the estimated present value of the resources required to fulfil an obligation. The objective of the risk adjustment should not be to convert the 'value in use' measure of the estimated present value of the resources required to fulfil an obligation (per paragraph 36B(a) of the ED) into a fair value/transfer price measurement. A fair value or transfer price reflects the cash flow expectations of other market participants, rather than those of the entity. A value in use measure that incorporates a risk adjustment may be materially less than the fair value or transfer price of the obligation. In such cases, an entity would not rationally pay that fair value or transfer price to be relieved of the risk that the actual outflows of resources might ultimately differ from those expected.

37. If the IASB proceeds with amending the measurement requirements in IAS 37, the AASB recommends providing additional guidance on the components of the above-mentioned risk adjustment, to assist consistent application of that requirement. If the IASB decides that the objective of the risk adjustment is to convert the 'value in use' measure of the estimated present value of the resources required to fulfil an obligation into a fair value/transfer price measurement, the need for additional guidance on the risk adjustment is particularly important. This is because, due to the infrequency with which provisions are transferred to other parties, there generally is a lack of observable transaction prices for transfers of obligations that provide market evidence of "the amount … the entity would rationally pay in excess of the expected present value of the outflows to be relieved of this risk" (as referred to in paragraph B15 of the ED).

38. An example of the need for further guidance is whether the above-mentioned risk adjustment includes an element for the entity's own credit risk. In view of the

potential significance of own credit risk to the measurement of liabilities, the AASB considers that proposed guidance should have been provided on this issue in the ED.

39. Similarly, the AASB considers that guidance should have been provided on whether the entity's own credit risk is taken into account when measuring the amount the entity would have to pay to cancel an obligation (referred to in paragraph 36B(b)) and the amount the entity would have to pay to transfer the obligation to a third party (referred to in paragraph 36B(c)).

40. If the entity's own credit risk is to be taken into account when measuring provisions, guidance should be provided on the treatment of changes in own credit risk. In this regard, the AASB notes the proposal in IASB Exposure Draft ED/2010/4 *Fair Value Option for Financial Liabilities* that, for all financial liabilities designated under the fair value option, changes in own credit risk should not affect profit or loss.

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 fulfil 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?

41. The AASB does not support this proposal.

42. In relation to obligations fulfilled by undertaking a service, the relevant outflows of resources required to fulfil each obligation are determined under paragraph B8(a) as follows:

> "if there is a market for a service, the amount is the price that the entity estimates a contractor would charge at the future date to undertake the service on the entity's behalf".

43. For the reasons provided in the comments above on Question 1, the AASB supports using contractor prices to measure provisions only when:

    (a) in estimating the present value of the resources required to fulfil the obligation [the measure under paragraph 36B(a) of the ED], it is likely that contractors will be used to help the entity to settle the obligation itself; or

    (b) the amount that the entity would have to pay to transfer the obligation to a third party [the measure under paragraph 36B(c) of the ED] is the lowest of the three measures set out in paragraph 36B.

44. In effect, the proposed guidance sets aside the measurement requirements in key paragraphs 36A and 36B of the ED, because it focuses on the nature of the promised item rather than the hierarchy of measures in paragraph 36B.

45. In addition, the AASB notes that, in Australia, many services that entities are obliged to provide either do not have observable prices, or have observable prices only in thinly-traded markets. This is because it often is most economic for entities to use their own resources to settle their service obligations. Therefore, depending on how 'a market for a service' should be interpreted (see the comments in paragraphs 27 – 29 of this submission), under the ED's proposals, many obligations to provide services might need to be measured under paragraph B8(b) at the amount the entity estimates it would charge another party at the future date to undertake the service.

46. As indicated in paragraph B8, the amount the entity would charge another party to undertake a service includes a profit margin on the estimated costs to provide the service. The AASB considers that adding a profit margin to the entity's own cost is inconsistent with the notion of the fulfilment value (the value in use equivalent) of the liability, and instead reflects aspects of a fair value measurement. The AASB also considers that adding a profit margin to the entity's own cost would diminish the usefulness of the measures of provisions for assessing the entity's future cash flows. As is noted in paragraph BC20(a) of the Basis for Conclusions on the ED, if the entity expects to use its own resources to settle an obligation to provide services, adding a profit margin reduces profit initially and causes the recognition of profit from the activity of settling the obligation. It is not clear why reporting such information would be useful to users in assessing the entity's future cash flows.

47. Another concern of the AASB with the proposal in paragraph B8(b) is that, when an entity does not charge other parties separately to undertake the service it is obligated to provide, there may not be reliable or verifiable information about the margin it would require (and obtain) on its own cost to undertake the service.

48. As noted in the comments on Question 1, the AASB proposes that the amount recognised under paragraph 36B(a) of the ED should be measured at the risk-adjusted expected cost of settlement, based on the most likely mode of settlement. This view applies equally to obligations fulfilled by undertaking a service and any other obligations within the scope of the Standard.

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 fulfil its contractual obligations, rather than the amounts the entity would pay a contractor to fulfil 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?

49. The AASB notes that the proposed limited exception for onerous contracts arising from transactions within the scope of IAS 18 and IFRS 4 reflects the different measurement approaches:

    (a) required for liabilities to customers in IAS 18 and being developed in Phase II of the Insurance Contracts project; and

    (b) proposed for provisions in this ED.

50. The measurement model required for liabilities to customers under IAS 18 (and proposed to be retained in the replacement Standard being developed for IAS 18) and being developed for some insurance contracts is based—at least initially—on the customer consideration amount (an historical input price). Liabilities to customers would only be remeasured if the contract is onerous. In contrast, provisions would continue to be measured by reference to estimated future outflows of economic benefits, and to be remeasured at each reporting date.

51. As noted in its comments on Question 1, the AASB recommends that the IASB develops high-level measurement principles for all classes of liabilities through its Conceptual Framework project. If this were achieved, there would be no need to provide the proposed limited exemption for onerous contracts arising from transactions within the scope of IAS 18 or IFRS 4. However, until such measurement principles are developed, the AASB would support the limited exception for the reasons set out in paragraphs BC23 – BC27 of the Basis for Conclusions on the ED.

APPENDIX A

Apparent inconsistencies within the ED

The apparent inconsistencies noted below arise either from explicit statements in the ED or from the potential for inconsistent application due to a lack of guidance on an aspect.

<table>
<tr><th>Reference</th><th>Inconsistency</th></tr>
<tr><td>Paragraphs 36A, 36B</td><td>The key measurement requirement in paragraph 36A refers to the amount that the entity would rationally pay <u>at the end of the reporting period</u> to be relieved of the present obligation. This implies an immediate settlement amount, which is inconsistent with the ‘value in use’ equivalent referred to in paragraph 36B(a). A similar disconnect exists in IAS 37. Paragraph 36 and the first sentence of paragraph 37 of IAS 37 imply an immediate settlement amount, although the remainder of the measurement guidance in that Standard is interpreted to include a ‘value in use’ equivalent. However, the disconnect is possibly worse in the ED because:

(a) IAS 37 refers to “the amount that an entity would rationally pay to settle the obligation at the end of the reporting period …” (paragraph 37); whereas

(b) the ED refers to “the amount that … (an entity) would rationally pay at the end of the reporting period to be relieved of the present obligation” (paragraph 36A).

It may be argued that, in IAS 37, ‘the end of the reporting period’ relates to the present obligation that exists at that time. However, this could not be argued in respect of the ED, because ‘the end of the reporting period’ clearly relates to when the entity would rationally make a payment to be relieved of the present obligation.

It may be useful to explain why an entity would rationally pay an amount at the end of the reporting period to be relieved of a present obligation (as per paragraph 36A of the ED) if, in respect of that obligation, the lowest of the amounts in paragraph 36B is the present value of the resources required to fulfil the obligation in a future period. Arguably, an entity would not rationally pay any amount at the end of the reporting period to be relieved of that present obligation, because it could fulfil the present obligation in a future period for a lesser amount.</td></tr>
</table>

Reference	Inconsistency
Appendix B, paragraph B7	Paragraph B7 seems not to belong in the scope of Appendix B. Appendix B deals with measuring the present value of the resources required to fulfil an obligation, which is the amount referred to in paragraph 36B(a) of the ED. Paragraph B7 provides guidance on the outflows to include when obligations are fulfilled by making payments to the counterparty. The amount that an entity would have to pay to cancel the obligation is referred to in paragraph 36B(b), and therefore it is unclear why paragraph B7 is included in Appendix B.
Appendix B, paragraphs B5(b) & B8	As mentioned in paragraphs 27 – 28 of the submission, there seems to be a potential inconsistency between the market evidence thresholds used in paragraphs B5(b) and B8, respectively. Paragraph B5(b) says estimates of the outflows of resources required to fulfil an obligation should be consistent with *observable* market prices, whilst paragraph B8 bases its distinction between using contractor prices and the entity's own prices on whether there is *a market* for the service (a less restrictive test). It is unclear why different market evidence thresholds are required in these paragraphs.
Appendix B, paragraph B8	There seems to be a potential inconsistency between the amounts referred to in paragraphs B8(a) and B8(b). Paragraph B8(a) says that, to determine the amounts an entity would rationally pay a contractor to undertake a service on the entity's behalf, if there is a market for the service, reference is made to the amounts a contractor would charge. Paragraph B8(b) says, to determine those amounts when there is not a market for the service, the entity estimates the amount it would charge another party to undertake the service. It is not specified whether the other party referred to in paragraph B8(b) is another business or a customer (in other words, it is unclear which market to refer to: a business-to-business market or a retail market). If the other party were a customer, the nature of the amounts described in paragraphs B8(a) and B8(b) would differ. That is, a price a contractor would charge to undertake a service (an exit price for the reporting entity in a business-to-business market) would differ in nature from a price the entity would charge a customer to undertake the same service (an entry price in a retail market). The price in a retail market would be greater (relative to a business-to-business price) by the amount the entity can charge to recover its costs of providing retail outlets and selling services, and would be reduced by any discount the entity provides to facilitate the acquisition of a customer relationship intangible. Therefore, the AASB recommends that the Standard clarifies whether the other party referred to in paragraph B8(b) is another business or a customer.

APPENDIX B

Differences between fair value and the proposed measurement requirements in IASB ED/2010/1 *Measurement of Liabilities in IAS 37*

As mentioned in the AASB's submission on IASB ED/2010/1 ('the IAS 37 Measurement ED'), the AASB is concerned that the ED's measurement proposals for provisions would increase the range of fair value-type measures in IFRSs (because some items would be measured at fair value while others, such as provisions, would be measured at amounts that incorporate important elements of a fair value measurement but differ from fair value in some respects). Those differences, and some potential differences, are discussed below.

Differences

Hypothetical exchange

In the IASB's *Fair Value Measurement* ED, fair value is based on the price at which market participants would hypothetically exchange an asset or a liability (FVM ED, paragraphs 12 and 13[7]). Restrictions on the entity's ability to transfer a liability are disregarded (FVM ED, paragraph 31[8]), because fair value is the price at which the liability would hypothetically be exchanged between the entity and market participants.

In contrast, the amount for which a provision could immediately be settled (through cancellation or transfer, per paragraphs 36B(b) and 36B(c) of the IAS 37 Measurement ED) is not a hypothetical settlement amount. Paragraph 36C of the IAS 37 Measurement ED says:

> "An entity might be unable to cancel or transfer some obligations within the scope of this Standard. 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 resources required to fulfil the obligation."[9]

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7 "In the absence of an actual transaction to sell the asset or transfer the liability at the measurement date, a fair value measurement assumes a hypothetical transaction at that date, considered from the perspective of a market participant that holds the asset or owes the liability. That hypothetical transaction notion establishes a basis for estimating the price to sell the asset or to transfer the liability. Because the transaction is hypothetical, it is necessary to consider the characteristics of market participants who would enter into a transaction for the asset or liability." (paragraph 12)

Paragraph 13 of the FVM ED says market participants are, among other things, willing and able to enter into a transaction for the asset or liability.

8 "A restriction on an entity's ability to transfer a liability to another party does not affect the fair value of the liability. This is because the fair value of a liability is a function of the requirement to fulfil the obligation. A market participant transferee would be required to fulfil the obligation and would take that into account when determining the price it would demand to assume the liability from the entity." (paragraph 31)

9 See also paragraphs BC6(a) and BC11 of the Basis for Conclusions on the ED.

Cancellation price

Cancellation price is one of the measures in paragraph 36B of the IAS 37 Measurement ED. However, it is not included in fair value because the FVM ED regards the fair value of a liability as a function of the requirement to fulfil the obligation.[10]

Own credit risk

Under the proposals in the FVM ED, an entity's own credit risk would generally be taken into account when measuring the fair value of a liability. Whether an entity's own credit risk would be taken into account when measuring a provision under the IAS 37 Measurement ED would seem to depend on which limb of paragraph 36B of that ED is applied. This is discussed below.

A provision is measured at its 'feasible transfer price' under paragraph 36B(c) of the IAS 37 Measurement ED, rather than at a price in a hypothetical exchange (as per a fair value measurement under the FVM ED). Because of this, an entity's own credit risk would apparently be treated differently in measurements under paragraph 36B(c) of the IAS 37 Measurement ED compared with fair value measurements under the FVM ED. The entity's own credit risk would not be taken into account in an actual transfer, as the transferee would not reward the transferor for any inferior credit standing. Unlike with fair value, the focus is not on the value of the liability equalling the value of the counterparty's asset. That is, under paragraph 36B(c) of the IAS 37 Measurement ED, whether a credit enhancement occurs in a transfer would be a non-issue.[11]

Own credit risk would probably be reflected in the cancellation price referred to in paragraph 36B(b) of the IAS 37 Measurement ED. If the party to whom a provision is owed agrees to cancel the obligation, they would weigh up the risk of non-payment by the obligor against the loss sustained by cancelling the obligation for less than its face value.

If a provision were measured at the present value of the resources required to fulfil the obligation (the value in use equivalent measure) under paragraph 36B(a) of the IAS 37 Measurement ED, the proposed guidance in that ED is unclear as to whether own credit risk

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[10] See footnote 8.

[11] The FVM ED proposes that "a fair value measurement assumes that the non-performance risk related to a liability (ie the risk that an entity will not fulfil an obligation) is the same before and after its transfer. Those who might hold the entity's obligation as assets would consider the effect of the entity's credit risk and other risk factors when pricing those assets. Accordingly, the exposure draft proposes that the fair value measurement for a liability should consider the effect of the reporting entity's own credit risk (credit standing) and other non-performance risk factors." (paragraph BC73)

"... market participants would not enter into a transaction that changes the non-performance risk associated with the liability without reflecting that change in the price. For example, a creditor would not generally permit a debtor to transfer its obligation to another party of lower credit standing, nor would a transferee of higher credit standing be willing to assume the obligation using the same terms negotiated by the transferor (debtor) if those terms reflect the transferor's lower credit standing." (FVM ED, paragraph 29)

would be taken into account. Therefore, it is unclear whether a difference may arise between the IAS 37 Measurement ED and FVM ED in this regard.

The IAS 37 Measurement ED says that amount takes into account the risk that the actual outflows of resources might ultimately differ from those expected (paragraphs B1(b) and, in particular, paragraphs B15 – B16). Guidance is not included on whether that risk adjustment includes an element for the entity's own credit risk.

Potential differences

'Performance guarantee'

It is not specified in the IAS 37 Measurement ED whether the amount the entity would have to pay to transfer the obligation to a third party (under paragraph 36B(c)) relates to a 'transfer with recourse'. In a transfer of an obligation with recourse to the reporting entity (obligor), the obligee (the original party to which the reporting entity had a present obligation) retains a right of recourse to the reporting entity if the transferee of the obligation (contractor) fails to perform as promised. In the IASB's earlier work on its Revenue Recognition project, a transfer with recourse was analysed as follows:

(a) the reporting entity transfers to a contractor the 'performance obligation' (the obligation to provide goods or services); while

(b) the reporting entity retains a 'performance guarantee' (the obligation to stand ready to remedy any failure by the contractor to provide the promised goods or services).

In contrast, in a transfer without recourse, the obligee relinquishes all claims against the reporting entity, and thus has no recourse to the reporting entity if the contractor fails to perform as promised.

If the amount the entity would have to pay to transfer the obligation to a third party (under paragraph 36B(c) of the IAS 37 Measurement ED) may be interpreted to relate to a 'transfer with recourse', that transfer price may exclude the price of the reporting entity's performance guarantee. If the price of the reporting entity's performance guarantee is excluded, the amount thus determined for the provision would differ from its fair value. This is because the fair value of a liability is determined as the price for a transfer without recourse.

Customer consideration amount if a market for a service does not exist (level 3 of the fair value hierarchy)

In relation to obligations fulfilled by undertaking a service at a future date, paragraph B8 of the IAS 37 Measurement ED says the relevant outflows for such obligations are the amounts an entity would rationally pay a contractor to undertake a service on the entity's behalf. In relation to estimating these amounts, paragraph B8(b) of the IAS 37 Measurement ED says, if there is not a market for the service, the entity estimates the amount it would charge another party to undertake the service.

It is not specified in the IAS 37 Measurement ED whether the other party referred to in paragraph B8(b) is another business or a customer (in other words, it is unclear which market to refer to: a business-to-business market or a retail market). If the other party were a customer, the amounts determined under paragraph B8(b) would differ from the fair value of the provision. The fair value of the provision would be the price a contractor would charge to undertake a service[12] (an exit price for the reporting entity in a business-to-business market). This amount would differ in nature from a price the entity would charge a customer to undertake the same service (an entry price in a retail market). The price in a retail market would be increased (relative to a business-to-business price) by the amount the entity can charge to recover its costs of providing retail outlets and selling services, and would be reduced by any discount the entity provides to facilitate the acquisition of a customer relationship intangible.

[12] Including assuming the performance guarantee.

APPENDIX C

Comments on issues remaining from the 2005 ED

The AASB is concerned about the following aspects of the IASB's 2005 ED (which proposed amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and IAS 19 *Employee Benefits*) that continue to be reflected in the Working Draft IFRS *Liabilities* placed on the IASB web site on 19 February 2010.

References below relate to the wording of the Working Draft IFRS.

Stand-ready obligations

The AASB is concerned that the potential scope of stand-ready obligations (as described in paragraph 19 of the Working Draft IFRS) is unclear and may be interpreted too broadly.

The issue relates to whether entities may consider themselves to be obliged to stand ready to meet the costs arising from unavoidable future events that are subject to existing laws in relation to occupational health and safety, redundancy, accident compensation and negligence claims. The AASB acknowledges that:

(a) paragraph 18 of the Working Draft IFRS says an entity does not have a present obligation if the entity can avoid the obligation through its future actions; and

(b) paragraph C12 of Appendix C of the Working Draft IFRS says an entity does not have a present obligation to rectify future damage even if the entity expects to cause further damage by continuing its operations.

However, sometimes an entity can avoid an obligation to stand ready to meet particular costs (like costs of accidents) only by ceasing to carry on an operation. It would be useful if the Standard were to clarify whether an ability to avoid an obligation by ceasing to carry on an operation would be sufficient grounds to conclude that a liability does not exist.

The distinction between liabilities (including stand-ready obligations) and business risks that is made in paragraph 17 of the Working Draft IFRS is important to identifying when a stand-ready obligation arises. However, how that distinction would be made is only explained by saying a business risk is not a present obligation. The AASB is concerned that insufficient guidance is provided to illustrate when a present obligation does not arise as a result of continuing to be exposed to outflows of economic benefits resulting from potential future events. In this regard, paragraph 19 of the Working Draft IFRS provides examples only of situations in which a stand-ready obligation exists, and examples of business risks are not provided.

Measurement issues regarding unconditional and conditional obligations

The AASB is concerned that the Working Draft IFRS does not clarify sufficiently the significance of the distinction between conditional and unconditional obligations for the identification and measurement of provisions. The AASB agrees that a conditional obligation

does not give rise to a liability, even though a related unconditional obligation does give rise to a liability.

Rather than referring to 'conditional obligations', the Working Draft IFRS refers to 'any new obligations that might arise if and when the future event occurs' (paragraph 19), but the meaning seems unchanged. The AASB notes that the principles of paragraph 19 of the Working Draft IFRS are consistent with the principles proposed in the 2005 ED (paragraphs 22 – 26). It remains confusing to effectively state that whilst conditional obligations do not create a present obligation, they should be taken into account when measuring a related unconditional obligation. This is confusing because it implies that when both types of obligations exist, the measured amount of the liability encompasses both conditional and unconditional obligations (even though conditional obligations are not of themselves liabilities).

APPENDIX D

AASB's editorial comments on the ED

Paragraph	Comment
Various	The AASB notes that the ED refers variously to 'obligations', 'present obligations' and 'liabilities' without any apparent difference in intended meaning. The AASB suggests using consistent terminology.
B8	The first sentence refers to "types of obligations (that) will be fulfilled by undertaking a service at a future date". The AASB notes that the *Shorter Oxford English Dictionary* defines 'undertake' as (*inter alia*): "To receive, accept; ... To take upon oneself; ...To give a formal promise or pledge; ... To ... commit oneself to ... an enterprise". Therefore, the AASB considers 'undertaking a service' to ordinarily mean promising to render a service. The act of promising does not fulfil an obligation. Accordingly, the AASB suggests replacing 'undertaking a service' with 'rendering a service'. However, where the ED refers to paying a contractor to undertake a service on the reporting entity's behalf (for example, in the second sentence of paragraph B8), it is appropriate to retain the expression 'undertaking a service'. This is because the context is different: another entity gives an undertaking, in return for consideration, to perform on the reporting entity's behalf. In the first line of paragraph B8(a), "a market for a service" should be replaced with "a market for the service", because the lead-in to paragraph B8(a) refers to a particular service. In this regard, see the first line of paragraph B8(b).
B15	In the first sentence, 'ultimately' is redundant because the sentence refers to 'actual' outflows of resources.
BC3(c)	The italicised text refers to 'investors and analysts'. There is no apparent reason for referring only to a sub-set of the primary users of general purpose financial reports. Therefore, the AASB suggests referring to 'existing and potential equity investors, lenders and other creditors', or just 'users'.
BC15(b)	In the last sentence, the AASB suggests replacing 'sensitive' with 'susceptible', because that sentence focuses on whether an estimation error occurs, rather than on the reaction to any estimation error.

Paragraph	Comment
BC21(e)	The AASB notes that the second sentence refers to activities that "create value for the capital providers". Such a proprietary perspective is inconsistent with the IASB's tentative decision to adopt an entity perspective to financial reporting. The AASB observes that the quoted words could be omitted without any loss of meaning, because the sentence also refers to an entity's activities that "are necessary for it to generate revenue". Accordingly, the AASB suggests omitting the quoted words.
BC22	In the last sentence, 'paragraph' should be inserted before 'B8'.