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ED 140 sub 2

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Mr David Boymal
Chairman
Australian Accounting Standards Board
PO Box 204
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21 September 2005
Our ref: DR:NG

Dear David

Re: ED 140 Proposed Amendments to AASB 137 *Provisions, Contingent Liabilities and Contingent Assets* and AASB 119 *Employee Benefits*

Deloitte Australia welcomes the opportunity to comment on the proposals contained in Exposure Draft ED 140 Proposed Amendments to AASB 137 *Provisions, Contingent Liabilities and Contingent Assets* and AASB 119 *Employee Benefits* (ED 140 or the 'exposure draft').

The purpose of our submission is to provide our views on the various matters discussed in ED 140 to assist the Australian Accounting Standards Board (AASB) in making its own submission to the IASB on the proposals, with the ultimate objective of developing a converged AASB Accounting Standard that is consistent with the proposed revised IAS 37 *Non-financial Liabilities*.

Overall we support the high level proposals contained in ED 140 to recognise non-financial liabilities, subject to the Board's consideration of our responses to the Specific Matters for Comment. We attach to this letter our responses to the specific questions raised in ED 140, together with other observations and matters for your consideration.

We have a number of areas of general concern with the ED:

- We support the objective of the Short-term Convergence project with the FASB. However, it seems to us that the ED proposals do not achieve convergence with US GAAP in certain key areas, including measurement of non-financial liabilities.
- There are a number of areas where the changes proposed to IAS 37 appear to be inconsistent with the *Framework*. We believe any proposed changes to the *Framework* should be made within the conceptual framework project.
- Much of the useful guidance on the application of the ED is contained within the Basis for Conclusions. We are concerned that the principles within the ED will not be appropriately applied if the material contained in the Basis for Conclusions is not readily available to preparers of financial statements. Therefore, we recommend the Board consider including the Basis for Conclusions as part of the revised Standard.
- The ED introduces a number of new concepts and requirements, such as conditional and unconditional obligations. We anticipate preparers will have difficulty understanding and applying these new principles in practice. Accordingly, the IASB should be encouraged to reword certain sections and,

where necessary, provide additional implementation guidance to reduce complexity of application to an acceptable level.

Ultimately, any Australian Accounting Standard issued by the AASB as a result of ED 140 must continue to fully maintain Australia's convergence with International Financial Reporting Standards. Whilst this is self-evident, it is incumbent upon the AASB to be a vocal supporter at the international level of pragmatic and rational solutions to the issues that have the greatest impact on Australian entities.

We also note that the comment period for ED 140 is poorly timed. With the transition to Australian equivalents to International Financial Reporting Standards (A-IFRS) in full swing, the majority of Australian entities are currently focussed on either full A-IFRS reporting in half-year financial reports, or alternatively finalising transition projects and full-year financial report disclosures under AASB 1047 *Disclosure of the Impacts of First-Time Adoption of Australian Equivalents to International Financial Reporting Standards*.

As a result, many entities may not have had a suitable opportunity to fully consider the proposals in relation to accounting for non-financial liabilities. It has also diverted the resources of the major accounting firms over this same period and reduced the opportunity for us to engage our clients in debate over the proposals in order to identify more of the practical issues surrounding the exposure drafts. We therefore suggest that the AASB request the IASB and FASB to extend the comment period on these proposals in order to elicit more complete feedback from constituents.

Due to the later submission deadline for the equivalent IASB exposure drafts, the global firm of Deloitte Touche Tohmatsu has not finalised its views in relation to the matters raised. Furthermore, in this letter we have highlighted issues and concerns in the Australian context that may not have the same degree of relevance internationally or which may not be considered of sufficient significance to warrant separate comment by the global firm of Deloitte in its submission. Therefore, the views presented in this document should be read in this context and may not necessarily represent the view of the global firm of Deloitte.

If you have any questions concerning our comments, please contact Darryn Rundell on (03) 9208 7916.

Yours sincerely

Darryn Rundell
Partner

MATTERS FOR SPECIFIC COMMENT – IASB

Question 1 – The Exposure Draft proposes to clarify that IAS 37, except in specified cases, should be applied in accounting for all non-financial liabilities that are not within the scope of other Standards (see paragraph 2). To emphasise this point, the Exposure Draft does not use 'provision' as a defined term to describe liabilities within its scope. Instead, it uses the term 'non-financial liability' (see paragraph 10). However, the Exposure Draft explains that an entity may describe some classes of non-financial liabilities as provisions in their financial statements (see paragraph 9).

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

We support the proposal to include within the scope of IAS 37 all non-financial liabilities not within the scope of other Standards.

However, consideration should be given to providing some guidance and/or examples of the additional liabilities the IASB believe will be now be included within the scope of the ED. It is unclear what liabilities (not covered by another standard) will be included within the scope of the ED that are not already included within the current version of IAS 37. For example, it is unclear whether a non-financial liability in the form of unearned income is within the scope of the ED.

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

We do not believe that 'provision' should be a defined term. In addition given the nature of the proposals in the ED, we find the use of the term 'provision' confusing and believe *all references* to the term 'provision' should be removed from the ED.

Our recommendation is supported by the comment in BC76 that:

> ...[t]he Board also understood that in some other jurisdictions the term 'provision' causes confusion. This is either because there is no clear distinction between a liability and a provision, or because 'provision' is used in that jurisdiction to describe an item that would not necessarily satisfy the definition of a liability. In at least one jurisdiction, 'provision' refers to an item in the income statement rather than in the balance sheet; in others it refers to asset valuation allowances.

Accordingly, we recommend that the following guidance contained in BC76 be excluded from the Basis of Conclusions. The relevant section of BC76 reads as follows:

> ...IFRSs do not specify how items should be described in financial statements and, thus, entities may continue to describe some liabilities as provisions in their financial statements...

Referring to the term 'provision' in the Basis for Conclusions, and specifically enabling entities to describe some liabilities as provisions in their financial statements is likely to result in further confusion.

Although it is not our preferred option, should the Board retain the comment that entities may continue to describe some liabilities as provisions in their financial statements, then we recommend that 'provision' should be a defined term within the ED. We note that without the benefit of reading the Basis for Conclusions it is unclear that entities are permitted to continue to disclose their non-financial liabilities as provisions in their financial statements.

Question 2 –The Exposure Draft proposes to eliminate the term 'contingent liability'. The Basis for Conclusions on the proposals in the Exposure Draft explains that liabilities arise only from unconditional (or non-contingent) obligations (see paragraph BC11). Hence, it

highlights that something that is a liability (an unconditional obligation) cannot be contingent or conditional, and that an obligation that is contingent or conditional on the occurrence or non-occurrence of a future event does not by itself give rise to a liability (see paragraph BC30).

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

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

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

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

We support the proposal to eliminate the term 'contingent liability' from IAS 37.

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

We do not support the proposed recognition of unconditional obligations independently of the probability that uncertain future events (conditional obligations) will occur (or fail to occur) because we do not believe the probability recognition criteria in the *Framework* will always be satisfied for unconditional liabilities purely because the entity is required to 'stand ready' to settle the obligation.

<u>Consistency with the *Framework*</u>

The current version of IAS 37 and ED 140 both require a liability to satisfy the definition of a liability in the *Framework* in order to be recognised.

The *Framework* currently defines a liability as:

> ....a present obligation of the entity arising from past events, the settlement of which is *expected to result* in an outflow from the entity of resources embodying economic benefits (para.49(b)). [emphasis added]

The *Framework* requires that a liability be recognised if:

> (a) it is *probable* that any future economic benefit associated with the item will flow to or from the entity; and
>
> (b) the item has a cost of value that can be measured with reliability (para.83). [emphasis added]

We concur with the guidance in BC37 which explains that a probable outflow of economic benefits as envisaged by the *Framework* may be interpreted to mean that it is more likely than not that that there will be at least *some* outflow of economic benefits even if there is significant uncertainty about the timing or amount.

We do not agree that although there may be uncertainty about the amount and timing of the resources that will be required to settle a liability, there is little or no uncertainty that settlement will require *some* outflow of resources. The basis for conclusions explains that the probability recognition criterion will always be satisfied because the entity has to 'stand ready' or provide services to settle the liability.

We believe that there may be instances where it is not probable that a conditional liability/contingency will result in an outflow of at least *some* economic benefits, for example if the condition on which the liability is based is extremely remote and 'standing ready' to settle has no associated outflow of economic benefits. However, we concur that due to the nature of non-financial liabilities it will be rare that settlement will not require *some* outflow of resources to illustrate that in most cases the probability recognition criteria will be satisfied with little or no analysis. Guidance to this effect would be useful.

<u>Question 3</u> – The Exposure Draft proposes to eliminate the term 'contingent asset'. As with contingent liabilities, the Basis for Conclusions explains that assets arise only from unconditional (or non-contingent) rights (see paragraph BC11). Hence, an asset (an unconditional right) cannot be contingent or conditional, and a right that is contingent or conditional on the occurrence or non-occurrence of a future event does not by itself give rise to an asset (see paragraph BC17).

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

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

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

We support the proposal to eliminate the term 'contingent asset' from IAS 37.

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

We support the proposal to include items previously described as contingent assets that satisfy the definition of an intangible asset within the scope of IAS 38.

<u>Scope of IAS 38</u>

We note that not all items previously described as contingent assets would necessarily be 'non-monetary'. Some items previously described as contingent assets may be 'monetary' and, as such, would not be within the scope of IAS 38, rather they would be accounted for in accordance with the requirements of IAS 39.

Application of IAS 38 to the cost of contingent assets

We are concerned that it is not clear what the 'cost' would be in relation to many assets previously disclosed as 'contingent assets' which now fall under the requirements of IAS 38.

Application of IAS 38 to the subsequent measurement of contingent assets

We are concerned that where an item previously described as a contingent asset is within the scope of IAS 38 it is not clear how any remeasurement required should be accounted for under IAS 38.

For example, IAS 38 currently requires intangible assets to initially be measured at cost, and subsequently:

- intangible assets measured using the cost model to be measured at cost less any accumulated amortisation and any accumulated impairment losses (para.74).
- intangible assets measured using the revaluation model to be measured at a revalued amount, being its fair value (para.75), and fair value must be determined with reference to an active market.

The measurement requirements of IAS 38 are not the same as IAS 37. That is, intangible assets are not permitted to be remeasured each reporting period to the amount that an entity would reasonably expect to recover at each reporting date unless an active market exists. The impact of this is that changes in the measurement of the asset due to changes in probability and amount will only be recognise when the asset is realised. This is inconsistent with the requirements of IAS 39.

Example – Court Case

Assume Entity A is an appellant in a court case in which they expect to be successful, however the outcome is uncertain. Based on our understanding of the ED, the asset would be recognised in accordance with the requirements of IAS 38.

In year 2 Entity A's estimate of the outcome becomes more certain and Entity A now expects to receive a substantial payment from the defendant. This change in estimate would not be permitted to be recognised by Entity A as the requirements of IAS 38 do not allow for remeasurement of the initial asset (unless revalued).

Consequently, we consider that the requirements of the ED for non-financial liabilities are not consistent with the requirements for assets previously disclosed as contingent assets. We recommend that the Board reconsider the requirements for assets previously disclosed as contingent assets, and specifically consider how the requirements of IAS 38 apply to such assets.

Question 4 – The Exposure Draft proposes amending the definition of a constructive obligation to emphasise that an entity has a constructive obligation only if its actions result in other parties having a valid expectation on which they can reasonably rely that the entity will perform (see paragraph 10). The Exposure Draft also provides additional guidance for determining whether an entity has incurred a constructive obligation (see paragraph 15).

(a) Do you agree with the proposed amendment to the definition of a constructive obligation? If not, why not? How would you define one and why?

We support the proposed amendment to the definition of a constructive obligation.

However, it is not clear to us whether the concept of a constructive obligation is applicable to obligations that are outside the scope of IAS 37, such as employee benefits. Therefore, we believe the concept of a constructive obligation is better elucidated within the *Framework* in addition to IAS 37. Constructive obligations are referred to (but the concept is not specifically defined) in other accounting standards such as AASB 119 *Employee Benefits*.

In our view this issue should be considered as part of the conceptual framework project.

(b) Is the additional guidance for determining whether an entity has incurred a constructive obligation appropriate and helpful? If not, why not? Is it sufficient? If not, what other guidance should be provided?

We support the inclusion of the additional guidance for determining whether an entity has incurred a constructive obligation within IAS 37.

However, with the exception of the areas specifically mentioned in the ED (onerous contracts, termination benefits and restructuring liabilities) it is not clear to us whether this guidance will result in any difference in treatment compared to current requirements.

Therefore, we suggest that the Board considers providing additional explanation and clarification as to why and how the proposed requirements will result in any difference in treatment compared to the current requirements of IAS 37.

Question 5 – The Exposure Draft proposes omitting the probability recognition criterion (currently in paragraph 14(b)) from the Standard because, in all cases, an unconditional obligation satisfies the criterion. Therefore, items that satisfy the definition of a liability are recognised unless they cannot be measured reliably.

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

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

Do you agree with the analysis of the probability recognition criterion and, therefore, with the reasons for omitting it from the Standard? If not, how would you apply the probability

recognition criterion to examples such as product warranties, written options and other unconditional obligations that incorporate conditional obligations?

We do not support omitting the probability recognition criterion from the Standard.

Consistency with the *Framework*

We consider that moving the probability criterion from recognition to measurement is not consistent with the *Framework*. As outlined below, both the current version of IAS 37 and ED 140 require a liability to satisfy the definition of a liability in the *Framework* in order to be recognised.

The *Framework* currently defines a liability as:

> ...a present obligation of the entity arising from past events, the settlement of which is *expected to result* in an outflow from the entity of resources embodying economic benefits (para.49(b)). [emphasis added]

The *Framework* requires that a liability be recognised if:

> (a) it is *probable* that any future economic benefit associated with the item will flow to or from the entity; and
>
> (b) the item has a cost of value that can be measured with reliability (para.83). [emphasis added]

We concur with the guidance in BC37 which explains that a probable outflow of economic benefits as envisaged by the *Framework* may be interpreted to mean that it is more likely than not that that there will be at least *some* outflow of economic benefits even if there is significant uncertainty about the timing or amount.

We do not agree that although there may be uncertainty about the amount and timing of the resources that will be required to settle a liability, there is little or no uncertainty that settlement will require *some* outflow of resources. The basis for conclusions explains that the probability recognition criterion will always be satisfied because the entity has to 'stand ready' or provide services to settle the liability. We believe that there may be instances where it is not probable that a conditional liability/contingency will result in an outflow of at least *some* economic benefits, for example if the condition on which the liability is based is extremely remote and 'standing ready' to settle has no associated outflow of economic benefits. However, we concur that due to the nature of non-financial liabilities it will be rare that settlement will not require *some* outflow of resources to illustrate that in most cases the probability recognition criteria will be satisfied with little or no analysis. Guidance to this effect would be useful.

Omission of the probability recognition criteria

It is unclear to us whether the probability recognition criterion has in fact been omitted from the Standard. Paragraph 12 of the ED states:

> ...items are recognised as non-financial liabilities in accordance with this Standard if they satisfy the definition of a liability in the framework.

Consequently we believe the body of the standard should include an explicit requirement to perform an assessment of whether it is probable that a liability will result in an outflow of at least *some* economic benefits and should not be based solely on whether an event will or will not occur. In some cases this assessment may require little or no analysis due to the nature of the obligation.

To avoid confusion and misapplication of the requirements by preparers, we recommend the concepts expressed in BC48 be included more prominently in the section on recognition.

The Board should also consider carefully rewording the 'Contingencies' section to make it clear that the probability criterion will always be met for unconditional obligations; therefore, there is no change to current practice.

Convergence with FASB

Any changes made to achieve convergence with FASB are nevertheless supported as an interim measure, and should be clearly identified as such.

Question 6 – The Exposure Draft proposes that an entity should measure a non-financial liability at the amount that it would rationally pay to settle the present obligation or to transfer it to a third party on the balance sheet date (see paragraph 29). The Exposure Draft explains that an expected cash flow approach is an appropriate basis for measuring a non-financial liability for both a class of similar obligations and a single obligation. It highlights that measuring a single obligation at the most likely outcome would not necessarily be consistent with the Standard's measurement objective (see paragraph 31).

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

We do not support the proposed amendments to the measurement requirements.

Removal of best estimate requirements

Specifically, we do not support the removal of the "best estimate of the expenditure required to settle the present obligation" criterion currently applied in IAS 37. Although the Board notes in the Basis of Conclusions that they believe "...this phrase sets out a clearer principle for measuring liabilities and is less likely to be misinterpreted than the notion of 'best estimate'" (BC79). In our opinion this requirement introduces uncertainty surrounding the appropriate measurement basis for a non-financial liability. Specifically, the requirement that "an entity should measure a non-financial liability at the amount that it would rationally pay to settle the present obligation *or* to transfer it to a third party on the balance sheet date" [emphasis added] may give preparers of financial statements the impression that they have a choice with regards to the measurement basis to be used. We believe the alternative measurement bases available to an entity should be limited to the manner in which the entity expects to settle the liability. While we believe the new measurement requirements are broadly consistent with the previous requirements and would make useful guidance we question the benefit associated with the change given the potential for misunderstanding.

BC78 states:

> The Board concluded that it would be inappropriate to make fundamental changes to the measurement objective of the Standard in this project given the board's more far-reaching project on the conceptual framework.

Use of credit risk in the measurement of non-financial liabilities

We are also concerned about whether and, if so, how an entity's credit risk is to be taken into account in the measurement of non-financial liabilities. There appears to be an inconsistency between the footnote to ED 139 paragraph E3 and ED 140 Example 17 – Measurement of a decommissioning obligation.

The footnote to ED 139 paragraph E3 states:

> For a liability, the estimate of fair value shall consider the effect of the liability's credit standing so that the estimate reflects the amount that would be observed in an exchange between willing parties of the same credit quality.

However, ED 140 Example 17 does not include any consideration of the credit risk of the entity. It is not clear why there is no consideration of credit risk of the entity in example 17. If this difference is intentional, then the implication is that there would be a 'day two loss' for business combinations because the credit risk would be taken into account in the initial recognition of the liability in accordance with ED 139, but then excluded in the measurement of the liability under ED 140. This is clearly not the intention of the Board. We recommend that the requirements of ED 139 and ED 140 be reviewed to ensure the requirements are consistent.

<u>Convergence with FASB</u>

Further, the Board acknowledges that the proposed measurement requirements of the ED are not converged with the FASB measurement requirements, which are based on a fair value measurement objective (BC77-78).

We support convergence with FASB and believe that the current FASB fair value approach is superior to that proposed by the ED. We agree with BC77 which states that:

> ...the FASB believes fair value is the most relevant and faithful representation of the underlying economics of a transaction.

If convergence with FASB is anticipated to be interpreted as a major change, we recommend that the current wording of IAS 37 be incorporated as guidance to the revised Standard.

We also note that a separate IASB project focusing on measurement bases for financial accounting is ongoing, and a discussion paper is expected to be issued in the near future.

<u>Appropriate measurement basis</u>

Therefore, in the absence of a conclusion on measurement objectives, and in the absence of convergence with FASB, the most appropriate measurement requirement is that currently adopted in IAS 37, being "the best estimate of the expenditure required to settle the present obligation at the reporting date" (para.36).

<u>Measuring a single obligation</u>

In addition, we do not support the proposed amendment to measuring a single obligation. We consider that measuring a single obligation on the same basis as a class of similar obligations is problematic as the cash flow information required to complete the measurement requirements is likely to be difficult to obtain. In addition, reliable market information is also likely to be difficult to obtain for many obligations. Therefore, in our view, in practical terms the conceptually superior approach is difficult to apply in practice.

Finally, we recommend that the examples included within the ED be revised to ensure they are more realistic. For example, the simplistic example in Example 17 is not realistic, because in reality it is generally a range of possible outcomes that occur, not 'point' outcomes as illustrated in the example. In addition, in practice there may be alternative methods of satisfying the obligation.

Question 7 – The Exposure Draft proposes that when an entity has a right to reimbursement for some or all of the economic benefits that will be required to settle a non-financial liability, it recognises the reimbursement right as an asset if the reimbursement right can be measured reliably (see paragraph 46).

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

We do not support the proposed amendment to the recognition requirements for reimbursements.

Reimbursement rights are recognised when they satisfy the definition of an asset and if they can be measured reliably (ED 140, para. 47). The Basis of Conclusions further notes that:

> ...the right to reimbursement should be recognised following the recognition criteria in the *Framework*, i.e. if it is probable that any future economic benefits associated with the asset will flow to the entity and the item has a value that can be measured reliably. The Board noted that the probability recognition criterion should be applied to the asset (i.e. unconditional right) and not the reimbursement (i.e. conditional right). This means that if an entity has a *right* to reimbursement, the probability recognition criterion would always be satisfied because the economic benefits embodied in the unconditional right are a certainty - there is no uncertainty that the entity has a right to look to another entity for reimbursement. The uncertainty relates to the amount of economic benefits that will flow from the conditional right. Because of this, and to ensure that entities do not incorrectly apply the probability recognition criterion to the conditional right, the Board concluded that it should specify as a recognition criterion only reliable measurement. The Board's view is that if the entity has recognised a non-financial liability and has an unconditional right to reimbursement, that right to reimbursement warrants recognition as an asset (BC91).

<u>Consistency with the *Framework*</u>

As previously noted, we are concerned the recognition criterion contained within the ED is not consistent with the recognition criterion in the *Framework*.

The *Framework* defines an asset as:

> ...a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity (para.49(a)).

The *Framework* requires that an asset be recognised if:

> (a) it is *probable* that any future economic benefit associated with the item will flow to or from the entity; and
>
> (b) the item has a cost of value that can be measured with reliability (para.83). [emphasis added]

As outlined in our response to Question 5 a probable outflow of economic benefits as envisaged by the *Framework* may be interpreted to mean that it is more likely than not that that there will be at least *some* inflow of economic benefits even if there is significant uncertainty about the timing or amount.

Consequently, if any change to the probability criterion is to be made then it is our view that it should be made within the context of the conceptual framework project. As such, this will ensure that the application of the *Framework* is consistent with the requirements of IAS 37.

<u>Omission of the probability recognition criteria</u>

As noted previously, it is unclear to us whether the probability recognition criterion has in fact been omitted from the Standard. Consequently we believe the body of the standard should include an explicit requirement to perform an assessment of whether it is probable that a reimbursement will result in an inflow of at least *some* economic benefits and should not be based solely on whether an event will or will not occur.

<u>Measurement of reimbursements</u>

Further, we recommend that the ED should detail how the reimbursement is to be measured. Currently, the only requirement appears to be that the reimbursement cannot exceed the amount of the non-financial liability. We are concerned with the requirement that the reimbursement cannot exceed the amount of the non-financial liability. If the reimbursement is greater than the costs associated with it, it is not clear why it would be inappropriate to recognise an asset for the excess above the value of the liability.

The requirements of IAS 38 cannot be used to measure reimbursements as reimbursements are specifically dealt with within the ED. AASB 1044 previously specified that recoveries receivable are measured in a manner consistent with the requirements relating to provisions (para. 6.2). We recommend that this requirement be addressed within the ED to ensure that there is no misunderstanding as to the appropriate measurement basis to use for recoveries.

Question 8 – The Exposure Draft proposes that if a contract will become onerous as a result of an entity's own action, the liability should not be recognised until the entity takes that action. Hence, in the case of a property held under an operating lease that becomes onerous as a result of the entity's actions (for example, as a result of a restructuring) the liability is recognised when the entity ceases to use the property (see paragraphs 55 and 57). In addition, the Exposure Draft proposes that, if the onerous contract is an operating lease, the unavoidable cost of the contract is the remaining lease commitment reduced by the estimated sublease rentals that the entity could reasonably obtain, regardless of whether the entity intends to enter into a sublease (see paragraph 58).

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

We support the proposed amendment to the onerous contract requirements.

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

We support the additional guidance for clarifying the measurement of a liability for an onerous operating lease.

We recommend that the Board includes additional commentary regarding the costs of finding a sub-lessee and whether these can be taken into account. Further, additional commentary should be included regarding whether a reasonable period of vacancy can be assumed in a similar manner to that which might be taken into account under IAS 40. IAS 40 specifically includes as an example of an investment property a building that is vacant but is held to be leased out under one or more operating leases (para.8).

We suggest that the Board revise the onerous contracts phrasing to ensure that the principles are able to be understood and applied appropriately in practice.

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

n/a.

Question 9 – The Exposure Draft proposes that non-financial liabilities for costs associated with a restructuring should be recognised on the same basis as if they arose independently of a restructuring, namely when the entity has a liability for those costs (see paragraphs 61 and 62).

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

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

We support the proposed recognition requirements for costs associated with a restructuring.

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

We consider the guidance for applying the Standard's principles to costs associated with a restructuring to be sufficient and appropriate.

Although we agree with the conceptual basis of the proposals we consider them to be a strong toughening of the current requirements of IAS 37. The commercial reality of restructuring is that the proposed change to the timing of liability recognition will be a substantial change to current business management processes. For example, many entities currently bring forward plans to restructure to periods of strong profitability. We anticipate that this substantial change will not be well accepted.

We recommend that the AASB give strong consideration as to whether this conceptual approach ensures a better outcome for financial markets.

Please refer to our separate submission on ED 139 for comments on restructuring arising as a result of a business combination.

MATTERS FOR SPECIFIC COMMENT - AASB

(a) whether constituents support the Board's preliminary view and/or share the Board's concerns with the proposed amendments.

As noted above we share the Board's concerns with the proposed amendments. One area of exception is in relation to restructuring provisions. The Board expressed concern that:

> ....the proposed general guidance in respect of the existence of constructive obligations may not always be consistent with the specific guidance on constructive obligations arising from restructuring arrangements.

We believe that this concern is unlikely to result in inconsistent application of IAS 37 in respect of the existence of constructive obligations because the overriding principle contained within IAS 37 that non-financial liabilities for costs associated with a restructuring should be recognised on the same basis as if they arose independently of the restructuring, namely when the entity has a liability for those costs (ED, para. 61 and 62).

(b) any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the proposals, particularly any issues relating to:

(i) not-for-profit entities

(ii) public sector entities

We support the inclusion of not-for-profit and public sector entities within the scope of the proposed ED.

(c) whether the proposals are in the best interests of the Australian economy.

We believe that the adoption of IFRS as converged Australian Standards will improve the ability of Australian entities to compete for funds in global capital market. Accordingly, we believe that the proposals are in the best interests of the Australian economy.

(d) whether constituents support the removal of the probability threshold for non-financial liabilities accounted for under IAS 37, and if not, whether the removal of the probability threshold is supported for non-financial liabilities assumed in a business combination.

As noted above, we do not support the removal of the probability threshold.

However, as noted previously, it is unclear to us whether the probability recognition criterion has in fact been omitted from the Standard. Rather, the ED assumes that probability will always be satisfied in relation to unconditional obligations, and never satisfied in relation to conditional obligations.

In relation to business combinations, we are concerned that where there is a conditional obligation of the acquiree that is taken into account by the acquirer at the date of the acquisition under a business combination this will result in no liability being recognised as it is entirely contingent.

An example might be a pending change in the law that would require substantial payments by the acquiree. An acquirer would take that factor into account in determining the purchase consideration for the business combination, and that factor would also affect the overall fair value of the acquiree . Not permitting recognition of a liability in the business combination has the effect of decreasing goodwill and the total effect of any subsequent law change would be recognised as an expense subsequent to the business combination – which, whilst conceptually is acceptable, does not reflect the commercial reality of these types transactions.