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23 September 2005

The Chairman
Australian Accounting Standards Board
PO Box 204
Collins St West
Victoria Australia 8007

Dear Chairman,

ED 140 – Proposed amendments to AASB 137 *Provisions, Contingent Liabilities and Contingent Assets* and AASB 119 *Employee Benefits*

Members of the Australasian Council of Auditors-General (ACAG) have been canvassed and submit the attachment in response to the exposure draft referred to above.

This represents the views of the Australian members of ACAG with the exception of the Auditor-General for South Australia who reserves his right to respond separately to auditing and accounting Exposure Drafts where he deems it appropriate, rather than as a member of ACAG.

In general, we support the proposed changes. The implementation of the proposed standard will result in the elimination of the terms contingent liabilities, contingent assets and provisions. New rules and guidance will also be introduced for constructive obligations, probability criterion, measurement, reimbursements, onerous contracts and restructuring provisions. Amendments to the employee benefits standard are proposed for the definition and recognition of termination benefits.

Our comments on specific matters are contained in the attachment.

The opportunity to raise comment is appreciated and I trust you will find the attached comments useful.

Yours faithfully

A handwritten signature in black ink, appearing to read 'M. Blake', with a long horizontal flourish extending to the right.

Mike Blake
Chairperson, ACAG Advisory Committee
23 September 2005

**ED 140 – PROPOSED AMENDMENTS TO AASB 137
PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT
ASSETS AND AASB 119 EMPLOYEE BENEFITS**

(References to ACAG below relate only to the Australian members of ACAG)

COMMENTS ON SIGNIFICANT PROPOSALS

ACAG reviewed each of the significant proposals of ED 140 and overall is in agreement with the views expressed in the exposure draft.

The comments provided below focus on those areas where it is considered that greater emphasis or clarification may be useful.

**PROPOSED AMENDMENTS TO IAS 37 PROVISIONS, CONTINGENT
LIABILITIES AND CONTINGENT ASSETS**

Question 1 – Scope of IAS 37 and terminology

The Exposure Draft proposes to clarify that IAS 37, except in specified cases, should be applied in accounting for all non-financial liabilities that are not within the scope of other Standards (see paragraph 2). To 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?*
- (b) *Do you agree with not using 'provision' as a defined term? If not, why not?*

(a) Agree.

(b) The exclusion of 'provision' as a defined term is tentatively supported. In our view, there is uncertainty on IASB's intention with respect to paragraph 9. Paragraph 9 states that some classes of non-financial liabilities may still be described as provisions in the financial statements. We believe clarification is required to ascertain whether paragraph 9 is implying that we can label (describe) liabilities as 'provisions' in the financial statements or that there are only some classes of liabilities that can be labelled as provisions. Alternatively, is it implying that some classes of liabilities are provisions? If the intention is that there are some classes of liabilities that are provisions, we believe that additional guidance is required in order to stipulate which type of classes the paragraph is referring to.

Question 2 – Contingent liabilities

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

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

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

The Basis for Conclusions highlights that many items previously described as contingent liabilities can be 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?*
- (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?*

- (a) Proposal to eliminate the term 'contingent liability' is supported.*
- (b) Support proposed changes.*

Question 3 – Contingent assets

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

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

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

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

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

- (a) Proposal to eliminate the term 'contingent asset' is supported.
- (b) The majority of items previously recognised as contingent assets that would now satisfy the definition of an asset should be classified as intangible assets. However, this would not be appropriate if the previously recognised contingent asset was in relation to a court case, whereby if successful, an entity would receive goods of a physical nature that have been quarantined pending a court resolution, for example.

Question 4 – Constructive obligations

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?*
- (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?*

- (a) The proposed amendment to the definition of a 'constructive obligation' is supported.
- (b) We also support the additional guidance contained within paragraph 15. However, we are of the opinion that more guidance is required in relation to paragraph 15 (c) to describe the types of benefits the other parties will receive if the entity performs on its constructive obligation, and provide examples of 'harm' for any non-performance by the entity.

That is, does the guidance refer to quantifiable financial benefits and harm or do reputation, share price and market share movements qualify as possible criterion for paragraph 15 (c)?

Question 5 – Probability recognition criterion

The Exposure Draft proposes omitting the probability recognition criterion (currently in paragraph 14(b)) from the Standard because, in all cases, an unconditional obligation satisfies the criterion. Therefore, items that satisfy the definition of a liability are 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?

Proposal supported. Analysis of the probability recognition criterion supports its removal from the Standard. However, consistent with the AASB's preliminary view,

careful consideration would be required to determine the effect of its removal on other Standards, and particularly the Framework.

Question 6 - Measurement

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

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

AASB's preliminary view suggests that there are two different measurement bases for non-financial liabilities. We believe the IASB's intention was that the measurement requirements in paragraph 29 are one and the same, based on our review of the supporting guidance paragraphs. If the intention is that there are two different measurement bases, consistent with AASB's view, we do not support the introduction of two bases.

Question 7 – Reimbursements

The Exposure Draft proposes that when an entity has a right to reimbursement for some or all of the economic benefits that will be required to settle a non-financial liability, it 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 reimbursement? If not, why not? What recognition requirements would you propose and why?

Proposal supported.

Question 8 – Onerous contracts

The Exposure Draft proposes that if a contract will become onerous as a result of an entity's own action, the liability should not be 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 the action? If not, when should it be recognised and why?*
- (b) Do you agree with the additional guidance for clarifying the measurement of a liability for an onerous operating lease? If not, why not? How would you measure the liability?*
- (c) If you do not agree, would you be prepared to accept the amendments to achieve convergence?*

(a) Proposals supported.

(b) The guidance on onerous operating leases is appropriate.

Question 9 – Restructuring provisions

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?*
- (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?*

Proposals supported. The recognition of restructuring liabilities and the guidance for costs associated with restructuring are appropriate and sufficient. We agree with the proposals to recognise restructuring costs as liabilities for each cost associated with the restructuring as the liability for each cost is incurred, instead of the current practice of recognising liabilities for all the costs associated with a restructuring as a single liability at a specified point in time.

PROPOSED AMENDMENTS TO IAS 19 *EMPLOYEE BENEFITS*

Question 1 – Definition of termination benefits

The Exposure Draft proposes amending the definition of termination benefits to clarify that benefits that are offered in exchange for an employee's decision to accept voluntary termination of employment are termination benefits only if they are offered for a short period (see paragraph 7). Other employee benefits that are offered to encourage employees to leave service before normal retirement date are post-employment benefits (see paragraph 135).

Do you agree with this agreement? If not, how would you characterise such benefits, and why?

Proposal supported. However, we suggest that additional guidance is included to clarify the term 'short period', described within paragraph 7.

Even though we do not consider it likely that different 'minimum retention periods' would exist, additional guidance would be useful for such situations, in order to clarify what takes precedence whereby the minimum retention period differs between law, contract, union agreements and past business practice.

Question 2 – Recognition of termination benefits

The Exposure Draft proposes that voluntary termination benefits should be recognised when employees accept the entity's offer of those benefits (see paragraph 137). It also proposes that involuntary termination benefits, with the exception of those provided in exchange for employees' future services, should be recognised when the entity has communicated its plan of termination to the affected employees and the plan meets specified criteria (see paragraph 138).

Is recognition of a liability for voluntary and involuntary termination benefits at these points appropriate? If not, when should they be recognised and why?

Proposals supported. The recognition of a liability for voluntary and involuntary termination benefits at the points described within paragraphs 137 and 138 are appropriate.

Question 3 – Recognition of involuntary termination benefits that relate to future services

The Exposure Draft proposes that if involuntary termination benefits are provided in exchange for employees' future services, the liability for those benefits should be recognised over the period of the future service (see paragraph 139). The Exposure Draft proposes three criteria for determining whether involuntary termination benefits are provided in exchange for future services (see paragraph 140).

Do you agree with the criteria for determining whether involuntary termination benefits are provided in exchange for future services? If not, why not and what criteria would you propose? In these cases, is recognition of a liability over the future service period appropriate? If not, when should it be recognised and why?

Proposals supported. The criteria detailed within paragraph 140 are appropriate in relation to benefits in exchange for future services. We also concur with the view to recognise a liability over the future service period.

SPECIFIC MATTERS FOR COMMENT

- 1. Whether constituents support the Board's preliminary views and/or share the Board's concerns with the proposed amendments?*

We support the preliminary views of the AASB and also share in their concerns with the proposals.

- 2. 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.*

With the imminent withdrawal of AAS 27, 29 and 31, guidance on the accounting treatment for non-exchange social benefits should be retained in some form.

- 3. Whether the proposals are in the best interests of the Australian economy?*

We are of the opinion that the proposals contained within ED 140 are in the best interests of the Australian economy.

- 4. 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?*

We support the removal of the probability threshold for non-financial liabilities accounted for under IAS 37. However, in concurrence with the preliminary view of the AASB, we believe an analysis of the issue at the 'Framework' level is required in order to identify any other implications of omitting the probability recognition criteria for liabilities and assets.

GENERAL MATTERS FOR COMMENT

No other general issues identified.