



**The Institute of
Chartered Accountants
in Australia**

5 October 2005

The Chairman
Australian Accounting Standards Board
PO Box 204
Collins Street West VIC 8007

Cc: Henry Rees, IASB

Dear Sir

Re: ED 140: Proposed Amendments to AASB 127 Provisions, Contingent Liabilities and Contingent Assets and AASB 119 Employee Benefits.

The Institute of Chartered Accountants in Australia (ICAA) welcomes the opportunity to make a submission on ED 140.

We do not support the proposals relating to the recognition and measurement of non-financial liabilities in this exposure draft as they seem to go against some of the basic tenets of accounting outlined in the Framework, namely, the going concern basis of accounting, and the qualitative characteristics of relevance and reliability. While less academically "elegant", to quote the Alternative View of a Board Member, our preference would be to retain the probability criterion in the interests of providing relevant information. Our detailed comments can be found in the appendix to this letter.

The proposals contained in this exposure draft are radical and will be confronting to many less technical accountants. The AASB needs to consider what it will do by way of education to assist its constituents, should these proposals be adopted.

Yours sincerely

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Appendix

Scope of AASB 137

AASB 137 defines a provision as a ‘liability of uncertain timing or amount’. The ED does not use ‘provision’ as a defined term and instead proposes using the term ‘non-financial liability’ which includes items previously described as provisions as well as other non-financial liabilities. The purpose of this proposed amendment is to clarify that AASB 137, except in specified cases, should be applied to all non-financial liabilities that are not within the scope of other Australian Accounting Standards. A consequence of this amendment and the amendments to contingent liabilities and contingent assets (as explained below) is that the title of AASB 137 is proposed to change to AASB 137 *Non-financial Liabilities*.

We agree with this proposal. The definition and use of the term “provision” has always been somewhat unsatisfactory and prone to misinterpretation.

Contingent Liabilities

AASB 137 defines a contingent liability as a possible obligation or as a present obligation that is not recognised. (A contingent liability that is a present obligation is not recognised either because it is not probable that an outflow of resources will be required to settle the obligation or because the amount of the obligation cannot be measured reliably.) AASB 137 does not permit contingent liabilities to be recognised but requires their disclosure, unless the possibility of any outflow of economic resources in settlement of the contingent liability is remote. The ED:

- (a) proposes eliminating the term ‘contingent liability’;
- (b) uses the term ‘contingency’ to refer to uncertainty about the amount that will be required to settle a liability rather than uncertainty about whether a liability exists; and
- (c) specifies that in the case of a liability where the amount required to settle the liability is contingent on one or more uncertain future events, the liability is recognized independently of the probability that the uncertain future event(s) will occur (or fail to occur).

The purpose of these proposed amendments is to:

- (a) clarify that only present obligations (rather than possible obligations) of an entity give rise to liabilities and that liabilities arise from unconditional obligations; and
- (b) require uncertainty about future events that affect the amount that will be required to settle a liability to be reflected in the measurement of the liability.

We agree with the analysis of contingent liabilities into an unconditional and a conditional element. We also agree with the more rigorous approach in the Basis for Conclusions BC27 whereby an entity must first work out whether it has a present obligation that satisfies the definition of liability and then approach the measurement of that obligation. We disagree with the measurement proposals and our arguments are given below, under our comments on measurement.

Contingent Assets

AASB 137 defines a contingent asset as a possible asset. It does not permit contingent assets to be recognised but requires them to be disclosed if an inflow of economic benefits is probable. The ED:

- (a) proposes eliminating the term ‘contingent asset’;

- (b) uses the term ‘contingency’ to refer to uncertainty about the amount of the future economic benefits embodied in an asset rather than uncertainty about whether an asset exists; and
- (c) proposes that items formerly described as contingent assets may be within the scope of IAS 38 *Intangible Assets* rather than IAS 37.

The purpose of the proposed amendment is to clarify that only resources controlled by the entity as a result of a past transaction or event (rather than possible assets) give rise to assets and that assets arise from unconditional rights.

We agree with the analysis as we did for contingent liabilities, but question how realistic it is to require these assets to be recognized under AASB 138. While such an asset can be recognized as part of goodwill in a business combination the recognition of internally generated goodwill is forbidden and these ex-contingent assets are unlikely to satisfy the stringent criteria of AASB 138 for recognition in their own right.

There is a problem with symmetry here. The IASB state that they want to make these alterations to bring the treatment of contingent liabilities into line with AASB 3. They have made changes which ostensibly mirror them for assets, but in practice do not, as the stringent requirements of AASB 138 prevent the recognition of these ex-contingent assets via internally generated goodwill or via the AASB 138 recognition tests. Effectively, by "fixing" the situation for contingent liabilities, they have brought about a situation whereby the treatment of such assets is different depending on whether they were acquired through acquisition (recognized in goodwill) or organic growth (generally unable to be recognized).

Constructive Obligations

AASB 137 defines a constructive obligation as an obligation that derives from an entity’s actions when the entity has indicated to other parties that it will accept particular responsibilities and, as a result, has created a valid expectation on the part of those other parties that it will discharge those responsibilities. The ED proposes to:

- (a) amend the definition of a ‘constructive obligation’ to clarify that the actions of an entity must result in other parties having a valid expectation that they can ‘reasonably rely’ on the entity to discharge its responsibilities; and
- (b) give additional guidance on determining whether an entity has incurred a constructive obligation.

We support the AASB’s preliminary view. The AASB is concerned that the proposed commentary in paragraph 15 on the existence of constructive obligations does not clearly identify that the ED aims to restrict the scope of constructive obligations as defined and understood in the current version of IAS 37. This may, in part, be attributable to the fact that it is difficult to foresee many circumstances when an entity can create a valid expectation in a counterparty that it will accept particular responsibilities even though the counterparty is unable to justify that it can reasonably rely on the entity to discharge its responsibilities. In other words, if a counterparty cannot reasonably rely on the entity’s undertaking, then it would appear difficult to argue that a valid expectation has been created.

Paragraphs BC54-BC60 of the IASB Basis for Conclusions confirm that the IASB’s intent is to restrict the circumstances in which a constructive obligation can exist,

however this is not readily apparent from the ED or, more importantly, from the proposed revisions to the definition of a constructive obligation.

In our view, if the IASB's intent was to tighten the standard, this should be clarified by means of an example comparing the impact of the new wording with the old. If this is merely a change in wording with no substantive impact, this should be clarified to constituents.

Probability Recognition Criterion

AASB 137 requires provisions to be recognised if it is probable that an outflow of resources embodying economic benefits will be required to settle the provision. In some cases, the examples accompanying AASB 137 apply this probability recognition criterion to what the ED identifies as conditional obligations. For example, in the case of a product warranty, AASB 137 explains that the entity considers the likelihood of claims arising under the warranty. In effect, this means that the entity considers whether it is probable that the conditional obligation will result in an outflow of resources embodying economic benefits. Consistent with the revised analysis of contingent liabilities, the IASB Basis for Conclusions explains that the probable outflow criterion should always be applied to the liability (that is, unconditional obligation). Therefore, if an entity has a non-financial liability arising from an unconditional obligation that is accompanied by a conditional obligation, the criterion is applied to the unconditional obligation rather than the conditional obligation. In the product warranty case, the criterion should be applied to the unconditional obligation to stand ready to honour warranty claims (that is, to provide warranty coverage). As a result, the IASB Basis for Conclusions highlights that the probability recognition criterion is always satisfied in relation to the unconditional obligation and therefore the ED proposes omitting the criterion from AASB 137.

In our view, this approach works for a portfolio of liabilities such as warranty claims, but produces some rather strange results if applied to a single liability, such as a law suit. We shall discuss this matter further under measurement, below.

Measurement

AASB 137 requires provisions to be measured at the best estimate of the expenditure required to settle the present obligation at the reporting date. The best estimate is described as 'the amount that an entity would rationally pay to settle the obligation at the reporting date or to transfer it to a third party at that time'. Although expected value is used as the basis of measuring a provision involving a large population of items, AASB 137 states that the best estimate of single obligations may be the 'individual most likely outcome'. The ED:

- (a) proposes that a non-financial liability be measured at the amount that an entity would rationally pay to settle the present obligation or to transfer it to a third party at reporting date;
- (b) emphasises that expected value can be used as the basis for measuring a non-financial liability for both a class of similar obligations and a single obligation; and
- (c) explains that measuring a non-financial liability for a single obligation at its most likely outcome would not necessarily be consistent with AASB 137's measurement objective.

In our view, the measurement requirements of this ED are flawed, particularly in respect of single obligations.

Firstly, they go against the fundamental principle of going concern. Para 29 states that “an entity shall 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.” If we look at Example 1 at the back of the standard, (disputed law suit) the entity would not be willing to pay anybody anything to assume the liability as it does not view itself as liable. To force an entity to put a value on this obligation is effectively to require it to restate its obligations on a fire-sale or liquidation basis and not on a going concern basis.

We appreciate that the intention of the IASB was to bring the treatment of these items into line with IFRS/AASB 3. The key difference is, however, that under IFRS 3, a business has been acquired and so it is quite legitimate to put a price on the assumption of a contingent obligation. The value of the business has crystallised at that point in time, because a transaction has taken place. Where an entity is continuing as a going concern and has no intention of off-loading the obligation, such a value is inappropriate under the going concern principles .

Secondly, the information provided by this mode of measurement is not relevant information to users, relevance being a key qualitative characteristic of financial reports under the Framework. The ED even admits as much in par 31: “a liability for a single obligation measured at its most likely outcome would not necessarily represent the amount that the entity would rationally pay to settle or to transfer the obligation on the balance sheet date”. We suggest that most users would find the amount the entity expects to pay more relevant than a theoretical figure calculated to represent how much the entity would have to pay to insure away a liability it has no intention of off-loading. The amount the entity expects to pay is probably also more reliable information, another attribute highlighted in the Framework.

Reimbursement

When expenditure required to settle a provision is expected to be reimbursed by another party, AASB 137 requires the reimbursement to be recognised when it is virtually certain that the reimbursement will be received. Consistent with the revised analysis of a contingent asset, the ED proposes that, if an entity has a right to receive reimbursement, that right be recognised as an asset if it can be measured reliably.

We support this proposed change.

Onerous Contracts

AASB 137 defines an onerous contract as one in which the unavoidable costs of meeting its obligations exceed the economic benefits expected. The entity recognises as a provision the present obligation under the contract. AASB 137 provides no further guidance about when the provision should be recognised. The ED proposes:

- (a) additional recognition guidance to specify that, when a contract becomes onerous as a result of an entity’s own action, the liability is not recognised until the entity has taken that action; and
- (b) to specifying that, in the case of an onerous operating lease, the unavoidable costs of meeting the obligation are based on the unavoidable lease commitment less any sublease rentals that the entity could reasonably obtain for the property regardless of whether the entity intends to sublease the property.

We support these proposed changes.

Restructuring Provisions

AASB 137 states that an entity has a constructive obligation for restructuring when it has a detailed formal plan for restructuring and has raised a valid expectation in those affected that it will carry out the restructuring has a constructive obligation. Therefore it recognises a provision for the direct expenditures arising from the restructuring. The ED proposes:

- (a) revising the application guidance for restructuring provisions to specify that a non-financial liability for a cost associated with a restructuring is recognised only when the definition of a liability has been satisfied for that cost. Accordingly, a cost associated with a restructuring is recognised as a liability on the same basis as if that cost arose independently of a restructuring; and
- (b) specific guidance for treating costs that are often incurred in a restructuring as follows:
 - (i) the cost of employee termination benefits is recognised in accordance with AASB 119 *Employee Benefits*;
 - (ii) a liability for costs that will continue to be incurred under a contract for its remaining term without economic benefit to the entity is recognised when the entity ceases using the right conveyed by the contract (in addition to any liability recognised if the contract was previously determined to be onerous); and
 - (iii) the cost of terminating a contract before the end of its term is recognised when the entity terminates the contract, in accordance with the contract terms.

We support the AASB preliminary view, namely that the AASB is concerned 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 suggest that the area of constructive obligations is still quite “woolly” (see comments above) and once the IASB has clarified its thinking in that area, the treatment of restructuring provisions will become apparent.

Definition of Termination Benefits

The definition of termination benefits in AASB 119 includes employee benefits that are payable as a result of an employee’s decision to accept voluntary redundancy in exchange for those benefits. The ED proposes that:

- (a) the definition be amended to clarify that benefits payable in exchange for an employee’s decision to accept voluntary redundancy are termination benefits only if they are offered for a short period; and
- (b) other employee benefits offered to encourage employees to leave service before normal retirement date are post-employment benefits.

We support these proposed changes.

Recognition

AASB 119 requires termination benefits to be recognised when the entity is demonstrably committed to either terminating the employment of employees before the normal retirement date or providing termination benefits as a result of an offer made in order to encourage

voluntary redundancy. The ED proposes that:

- (a) voluntary termination benefits be recognised when employees accept the entity's offer of those benefits; and
- (b) involuntary termination benefits be recognised when the entity has communicated its plan of termination to the affected employees and the plan meets specified criteria, unless the involuntary termination benefits are provided in exchange for employees' future services (that is, in substance they are a 'stay bonus'). In such cases, the liability for those benefits is recognised over the future service period.

We support these proposed changes.