ED 191 sub 1

Department of Treasury and Finance

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Mr Kevin Stevenson
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Dear ~~Mr Stevenson~~ Kevin

EXPOSURE DRAFT 191 MEASUREMENT OF LIABILITIES IN AASB 137

The Heads of Treasuries Accounting and Reporting Advisory Committee welcomes the opportunity to provide comments to the Australian Accounting Standards Board on the International Accounting Standards Board Exposure Draft *Measurement of Liabilities in IAS 37*.

HoTARAC does not support the proposed changes to the measurement of liabilities. Additionally, HoTARAC opposes the fundamental changes made to the concept of a liability, and considers that, if required, debate on this issue is more appropriate as part of the IASB's Conceptual Framework Project.

Furthermore, HoTARAC does not agree with the processes undertaken by the IASB in issuing the "limited" Exposure Draft and with a reduced comment period. This is not the first time that IASB processes have been a cause for concern in recent years, as there was also negative reaction to the changes to financial instruments Standard. HoTARAC recommends that the AASB makes appropriate representations about IASB process issues.

Comments by HoTARAC on questions from the Exposure Draft are in Attachment 1.

If you have any queries regarding HoTARAC's comments, please contact Peter Gibson from the Department of Finance and Deregulation on (03) 6215 3551.

Yours sincerely

D W Challen
CHAIR
HEADS OF TREASURIES ACCOUNTING AND REPORTING ADVISORY COMMITTEE

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Encl

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Attachment 1

HoTARAC Response to ED 2010/1
Measurement of Liabilities in IAS 37

General Comments

The IASB made some further changes to the proposals from the 2005 ED in response to the feedback received. However, except for the "measurement" component, the IASB decided not to re-expose those proposals.

It is difficult to make comment without seeing how the measurement components will fit in the proposed new Standard (especially in relation to recognition). The IASB released a working draft of the entire Standard in late February 2010 (however it did not invite comments on this document). This is a departure from the normal "due process" followed by the IASB in developing standards. Due to the reduced comment period, HoTARAC was unable to consider the working draft in its response.

The 90 day comment period, rather than the normal 120 day, does not seem justified given that this is a complex and contentious issue, as indicated by six IASB members. Also, as noted, it is difficult to comment in the timeframe provided given that the working draft of the full proposed Standard was not available until nearly half way through the comment period.

HoTARAC does not support the IASB proposed changes to the concept of a liability through a Standard. These changes would be more appropriate through the IASB's Conceptual Framework Project, rather than this piecemeal approach. The proposed amendments will change the concept of a liability and are not consistent with the current IASB Conceptual Framework and business reality. It is of concern to HoTARAC that projects on revenue, insurance and liabilities are returning different answers on substantively similar obligations which will increase inconsistencies in the treatment of liabilities, without justifiable reasons.

HoTARAC is of the opinion that there appears to be a lack of a clear and overarching measurement objective. The ED adopts an exit value principle, which is not clearly identified as fair value, but applies a hybrid measure including a mixture of entity specific and market inputs. This is not necessarily consistent or considerate of other IASB projects, for example, revenue recognition, insurance, the measurement phase of the Conceptual Framework and fair value measurement.

HoTARAC does not agree that the use of a statistical method based on possible outcomes and probabilities is generally reliable for single obligations, where it can only be supported by limited evidence. For example, where there is no past experience, and particularly where these obligations are improbable or remote. It is HoTARAC's view that recognising obligations on such a basis will undermine the reliability and credibility of financial statements.

However, to assist the IASB, detailed comments by HoTARAC are provided below.

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?

Initial measurement

36A HoTARAC does not support the proposed requirement.

HoTARAC does not consider the change of terminology from "provision" to "liability" and "settle" to "relieved" has been justified.

HoTARAC understands that the term "liability" continues on from the 2005 ED, although it was referred to as a non-financial liability. However, HoTARAC does not support the fundamental change to the concept of a liability and is generally more supportive of the current provision and contingent liability concepts.

Additionally, HoTARAC does not agree with the term liability being used throughout the ED as, generally speaking, the notion of a liability encompasses both non-financial and financial liabilities. HoTARAC acknowledges that the scope, from the 2005 ED, excludes those liabilities covered by other Standards, however, the use of the term "liability" could lead to confusion.

HoTARAC is of the opinion that the proposal is not consistent with the Framework's definition of a liability. In relation to the term "relieved", separated into the terms "fulfil", "cancel" and "transfer" in 36B, HoTARAC notes that the Framework (and Appendix A of the ED) uses the term "settle" in defining a liability. HoTARAC does not support a differentiation between the Framework and the ED's definition of a liability and the approach taken in 36A to use "relieve".

36B (includes Appendix B) HoTARAC does not support the proposed requirements.

This is principally due to the measurement requirements contained in Appendix B. Given that 36B refers to Appendix B for measurement guidance, HoTARAC has provided detailed comment on both 36B and Appendix B.

Paragraph 36B:
If an entity has the ability to cancel or transfer its obligation, should the obligation be measured at the lower amount of the three? HoTARAC considers that it would probably be the most rational amount to be paid, therefore, that particular requirement of 36B is supported by HoTARAC.

However, further guidance should be outlined on how, in practice, this would apply. For example, an entity may be bound under a contract which specifies the cost of an opt out clause. Under the proposed ED, it seems that this is what the liability should be measured at, that is, the opt out amount may be the lower of the three valuation methodologies in paragraph 36B. This may result in an understatement of liabilities, because, at reporting date, management may have no intention of opting out but fully intend to continue with the contract obligation.

Appendix B:
In evaluating the measurement guidance in Appendix B, HoTARAC notes a key word in the requirements of 36A “rationally”. HoTARAC does not consider the measurement requirements in Appendix B determine an amount that would be rationally paid at the end of the reporting period. Accountants and business management would generally view the expression “the most rational amount to be paid” would be based on business/commercial rationale for making the decision, not the uncertainty/risk. That is, does it make business sense to pay at the provision amount if there is a more favourable alternative which would result in a better financial position for the entity?

The measure is based on the probability weightings of all the possible outcomes. Including those that may only have a five per cent chance seems unrealistic/business irrational (refer Illustrative Example provided at the back of the 2010 ED), as the entity would calculate an amount that the entity would be unlikely to pay, which would not be decision-useful. HoTARAC agrees with some of the comments in BC13 which oppose the ED’s measurement basis of “expected value” and prefers the “most likely outcome” method. In particular, HoTARAC support comment (a), which highlights that the ED’s proposed measurement is an irrelevant measure that provides an amount that the entity will not pay. Therefore, paragraph 36A requires an entity to measure an amount that would be “rationally paid”.

HoTARAC cannot follow some of the rationale behind the Board’s comments in BC14, BC15 and BC16 disagreeing with the views of many of the respondents to the 2005 ED that are outlined in BC13. However, HoTARAC does note that an entity may choose to pay at the five per cent outcome under certain circumstances. This would ultimately depend on the entity’s business circumstances and its appetite for risk. Therefore, a low probability outcome should not be a presiding factor in the calculation of a liability.

Additionally, HoTARAC is of the opinion that paragraphs B3(a) and B4 conflict with each other and will raise issues in applying the expected present value technique. B3(a) involves identifying each possible outcome and then B4 states that it is not always necessary to consider distributions of all possible outcomes. Rather, a limited number of discrete outcomes and probabilities can often provide a reasonable estimate. Issues would arise between the preparers and the auditors in relation to the interpretation of these two paragraphs. If B3(a) is followed, then identifying each/all possible outcomes, especially those with a small probability seems costly and not that useful. If B4 is followed, there is the potential for data manipulation due to the choice that management would have.

There is also no guidance as to determining the limited number required to provide a reasonable estimate. How “low” should a probability-weighting be considered, and should a probability-weighting of somewhere between one and five per cent really be considered in the calculation? The associated outcome of such a weighting would not be realistic because, although it may be “possible”, it is more than likely not “probable”. Either way, in B3(a) and B4, the issue of materiality has not been considered; however, in the Basis for Conclusions, the Board states that “rationally, an entity would take into account all material outcomes” (BC28).

HoTARAC considers that further guidance would be required on how to measure a liability resulting from a contract with highly complex milestones or performance benchmarks to be achieved.

HoTARAC has concerns with the guidance provided on risk margin (B15-B17). Most notably, HoTARAC is uncertain as to whether this risk margin includes credit risk and the extent to which the risk is diversifiable. Given the uncertainty, HoTARAC is concerned that the insufficient guidance and lack of clarity will result in subjectivity. Therefore, HoTARAC agrees with the alternative views AV5 and AV6 on this matter because it is not clear what the risk adjustment is intended to represent. For example, HoTARAC recommends that the Illustrative Example at the end of the ED explains how the “arbitrary” five per cent risk adjustment was determined.

Further, the ED proposals are based on a value to settle at the reporting date not the cost to fulfil the obligation over its term. As a result, HoTARAC considers that it is a hybrid measure, as it makes a risk adjustment to the cash flows. For example, the amount the entity would pay in excess of present value to be relieved of the risk, which mixes entity specific and market/exit value concepts.

36C HoTARAC supports the proposed requirement.

It is HoTARAC’s view that 36C acknowledges that not all obligations are likely to have the ability to be transferred and/or cancelled.

36D HoTARAC supports the proposed requirement.

HoTARAC is of the opinion that the amount that would be included to cancel or transfer an obligation appears to be the amount that would be "rationally paid", as in those circumstances that is the probable outcome.

Subsequent measurement

36E and 36F HoTARAC does not support the proposed requirements.

HoTARAC's view on these two paragraphs is primarily based on the fact that it does not support the proposed measurement of liabilities which 36E relies on. However, HoTARAC does support the change in heading from "Changes in Provisions" to "Subsequent Measurement". HoTARAC considers this to be clearer and more consistent with the heading used in various other Standards for subsequent measurement.

Consistency between initial and subsequent measurement is an appropriate methodology. However, as discussed in relation to Appendix B, it is unclear whether the risk margin includes credit risk, B18(c) requires that the risk that the actual outflows of resources might ultimately differ from those expected be considered. HoTARAC does not support the inclusion of credit risk in the subsequent measurement of liabilities. Please refer to HoTARAC's comments on IASB Discussion Paper 2009/2 *Credit Risk in Liability Measuremen*t for more information. Therefore, HoTARAC does not support B18(c) if it implies the inclusion of credit risk.

Additionally, HoTARAC considers that the guidance on subsequent measurement is insufficient as to how an entity would treat a situation where it could not initially transfer/cancel but now can (or vice versa), or where there is less/more available evidence regarding there being less/more possible outcomes. The guidance only provides that "changes in estimates faithfully represent changes in conditions during the period" (B19). The transfer/cancel issue arises from initial measurement being the lowest value of "fulfil", "cancel" and "transfer", and where the entity is unable to cancel or transfer it then uses fulfil (36B and 36C). The subsequent measurement paragraphs and guidance do not provide for this.

Moreover, HoTARAC notes that the ED removes the requirement for a provision (liability) to be reversed when it is no longer probable that an outflow will be required to settle the obligation.

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?

HoTARAC does not support the proposal in Paragraph B8.

As per the AASB's preliminary view, for an entity that would undertake the service itself, a hypothetical profit would be recorded. HoTARAC cannot see how such information could be considered useful for any financial statement user.

HoTARAC understands that the IASB is focusing more prominently on "fair value" measurement and HoTARAC is supportive of fair value measurement where warranted. While the IASB is developing a fair value measurement ED, HoTARAC is concerned that it is also not examining what should be measured at fair value and whether measurement objectives specified or proposed in a Standard such as this are essentially fair value, or, if not, what is the measurement model to be applied. For example, in a situation where an entity will undertake the service itself it seems incomprehensible for that entity to charge itself a profit margin, as it could potentially create subjective earnings management. Thus, using a market price (fair value) in this situation is undesirable when the entity would be able to reasonably estimate the costs it would incur itself and knowing that the entity would not "receive a profit" (proposed "no market" based measurement) or "pay a margin" (proposed "market" based measurement) for such service. Ironically, HoTARAC notes that the proposal allows for entities who conduct the service where there is no market, to supplement the information that it would obtain from a market with its own costs and then add the margin.

Also, in cases where the entity decides to undertake the service in-house because it has the expertise and it is more cost effective to do so, HoTARAC considers that the organisation would and should be able to measure the provision at its own costs. This information would be more useful to users, as it would better reflect the expected outflows as opposed to the proposal in the ED. It is HoTARAC's view that an issue may arise in measuring the service where the entity undertakes the service itself, where there is no market and the entity does not have the expertise. The ED lacks guidance as to how such a service should be appropriately measured, given that the ED assumes that the entity would have the expertise of costing such an activity.

Additionally, HoTARAC is of the opinion that the ED lacks guidance as to what constitutes a market and determining whether or not there is such a market. This guidance is considered by HoTARAC to be a critical component given that how an entity is required to measure a future service differs based on whether or not there is a market. If there is only one contractor that can provide such a service, does that constitute a market?

HoTARAC agrees with many of the comments in BC20 which support measuring future outflows at the expected costs of undertaking the service, which the IASB rejected as a measurement principle. HoTARAC does not agree with some of the comments in BC21 which supports the ED's measurement proposal. Some of the comments in BC21 are confusing, in particular comment (c); "calculations based on contractor prices could be easier to prepare and verify than those based on accumulations of costs and allocations of overheads". HoTARAC considers that the calculated figure should have the objective of being "relevant" rather than simply being easier yet irrelevant to the associated liability. Comment (d) of BC20 considers that guidance could be provided as to the costs that should be included, just like IAS 2 *Inventories*. Also, comment (c) of BC20 points out that in the absence of a market, the entity would need to estimate its own future costs and add a profit margin that is subjective and open to manipulation.

HoTARAC agrees with the alternative views of the six dissenting Board members as outlined in AV2(b) and AV2(c). These alternative views are repeated, with added emphasis, below:

> "In contrast, if an entity expects to fulfil an obligation in the scope of IAS 37 ***by undertaking the service itself, the margin*** that the entity would have charged a customer or a margin that a contractor would have charged the entity for the activity ***is non-existent***. It is a ***hypothetical amount*** that does not represent a payment of cash or an actual outflow of the entity's resources. ***Including a hypothetical margin*** in the measurement of the liability ***would reduce the net profit at the initial recognition*** of the liability ***and release a profit in the period in which the liability is derecognised***. These Board members believe that such accounting ***creates inappropriate performance information*** for both periods and does not provide useful information to the users of financial information. They also believe that such a measurement method ***does not help in predicting the entity's capacity to generate cash flows in the future***."

> "Paragraph B8 requires an entity to refer to the price a contractor would charge, if a market exists. The Board asserts in paragraph BC21(a) that there is a market for most types of service. These six Board members disagree. Furthermore, there is ***no guidance about what constitutes a market*** and whether a referenced market should be a liquid market with observable market prices. There is also ***no guidance about how to determine the margin when there is not a market*** for the service. In the view of these six Board members, the ***lack of guidance*** will ***lead to*** unacceptably ***wide variation in the margins*** that different entities include ***for similar obligations*** and ***provide a means of earnings management***."

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?

The majority of HoTARAC support the exception.

HoTARAC notes that the exception is due to the Board's wait for the completion of the revenue recognition and insurance contracts projects.

However, HoTARAC considers that insurance could normally be a case where contractor costs would represent a realistic cost, as most services are not provided by the insurance company itself.

A minority of HoTARAC members do not support the exception as specified. Rather, the minority's view is that the measurement exception for onerous contracts (which are permitted to continue to be measured based on a cost of fulfilment basis rather than the value to settle) illustrates the conceptual flaw with the proposals. The minority considers there to be little justification to have an exception for onerous contracts but not for other types of liabilities such as warranties. Also, the inclusion of a cost basis for onerous contracts in the IASB's Preliminary Views Paper on Revenue Recognition, illustrates that there is no overarching principle being applied to essentially identical obligations.

Additional Comments

HoTARAC also considers the following issues to be of importance in the development of a replacement Standard on Liabilities:

Due process

HoTARAC strongly agrees with alternative view AV7 because there is a significant change to the concept of a liability, and, as stated in AV7, “most respondents to the 2005 Exposure Draft opposed, and continue to oppose, aspects of the proposals that the Board is not now re-exposing”. It is HoTARAC’s opinion that the IASB should re-expose the entire proposed Standard to ensure that respondents can provide a more complete analysis of the proposals. As previously noted, HoTARAC considers that it is difficult to provide an adequate response without being able to properly assess all of the changes.

Scope of the Standard (AASB public sector issue)

HoTARAC is of the view that there could be a significant impact on statutory guarantees. These would be recognised on the Balance Sheet, rather than disclosed as a contingent liability. Given statutory items are not contracts (AASB 132.AG12), they would not be covered by the financial instruments suite of Standards.

What if the most likely outcome is less than 50 per cent?

Given that the IASB has removed the probability requirement, the proposals would require a liability with a probability of less than 50 per cent to be recognised.

Practical aspects

Given that the proposals would require the inclusion of all outcomes and annual assessments, HoTARAC is of the opinion that these requirements would result in high volatility which would not reflect business reality. HoTARAC considers that provisions need to be reversed when they are no longer probable.

Impact of eliminating the probability recognition criteria on measurement

HoTARAC is concerned that, by omitting the probability recognition criteria, reliable measurement becomes problematic. In this regard, HoTARAC does not accept the Board’s conclusion that it is only in “extremely rare situations” that a liability cannot be measured reliably (BC15). Rather, HoTARAC is of the opinion that for single obligations this may be a relatively common occurrence. HoTARAC does not agree that the use of a statistical method is generally reliable where it can only be supported by limited evidence (with no past experience) and particularly where these obligations are improbable or remote. It is HoTARAC’s view that recognising such liabilities based on an expected value approach will be highly subjective and undermine the reliability and credibility of financial statements.

Highest and best use

The current proposal refers to situations where an entity is unable to cancel or transfer obligations and where there is no evidence the entity could do so for a lower amount (36C). HoTARAC suggests that the Board could make this clearer by considering the fair value measurement project and the concept of “highest and best use” as applied to assets. That is, in HoTARAC’s view, where it is not legally permissible and financially feasible to transfer or cancel a liability, then the liability must be measured assuming the entity itself will retain and fulfil the performance obligations (that being the cost of fulfilling the obligation). HoTARAC considers that this concept could equally be applied to liabilities and should be further considered in both the liabilities and fair value measurement Projects.