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

24 May 2010

Dear Kevin

Exposure Draft ED 191 *Measurement of Liabilities in AASB 137*

I am enclosing a copy of the PricewaterhouseCoopers response to the International Accounting Standards Board's exposure draft ED/2010/1 *Measurement of Liabilities in IAS 37*. The letter reflects the views of the PricewaterhouseCoopers network of firms and as such includes our own comments on the matters raised in the exposure draft.

Whilst we do not support the proposals in the exposure draft, we do not see our concerns as providing a basis for the AASB departing from the standard if the IASB ultimately decides to proceed with the proposals. We remain committed to the view that it is in the best interest of the Australian economy for the AASB to issue standards that are the same as those issued by the IASB.

However, in so far as the standard applies to entities in the public sector, we would support an exemption for those entities in relation to obligations arising from existing public policies, budget policies, election promises or statements of intent, until such time as the AASB has completed its consideration of the recognition and measurement of these types of obligations.

We would welcome the opportunity to discuss our views at your convenience. Please contact me on (03) 8603 3868 if you would like to discuss this further.

Yours sincerely

Jan McCahey
Partner
Assurance

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Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
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18 May 2010

Dear Sir,

Re: IASB Exposure Draft: Measurement of Liabilities in IAS 37

We welcome the opportunity to respond to the Exposure Draft: 'Measurement of Liabilities in IAS 37" (the 'Exposure Draft'). We have also commented in this letter on some of the other principles in the Working Draft of the IFRS: 'Liabilities' (the 'proposed standard') published on 19 February 2010.

Following consultation with members of the PricewaterhouseCoopers network of firms, this response summarises the views of the member firms that commented on this Exposure Draft. 'PricewaterhouseCoopers' refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

We acknowledge the Board's objective of improving the guidance for the recognition and measurement of liabilities not covered by other standards ('non-financial liabilities'). We support this objective in principle, but for the reasons described below and in our responses in Appendix A to the questions posed in the Exposure Draft, we do not believe the Board should proceed with the proposed changes. We are concerned that the proposed standard will cause significant practical difficulty for preparers and will result in greater diversity in practice without providing more relevant or decision-useful financial information.

The proposed standard could have a pervasive impact on existing practice, and it does not fully address all of the concerns expressed in our response on the 2005 exposure draft. Given the significant time that has elapsed since the 2005 exposure draft was issued, we believe that the proposed standard should be re-exposed in its entirety and subject to due process if the Board intends to proceed to a final standard.

The existing standard has been in place for many years and is sufficiently well understood and consistently applied in most areas. There is no urgent need at this time for a fundamental change in the underlying principles for the recognition and measurement of non-financial liabilities, especially given the demands of other significant projects on the Board's time. We acknowledge that there is limited diversity in the way some aspects of the existing standard are applied. We believe this diversity would be addressed more effectively through less significant amendments to the existing standard. We have set out in Appendix B some suggested areas for improvement.

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Recognition

We do not believe that the recognition principles for non-financial liabilities should be revised as proposed.

Information about an entity's obligations is most useful when it enables users of the financial statements to understand the obligations and predict the future cash outflows required to extinguish those obligations. It is therefore important that any standard for non-financial liabilities includes clear guidance to determine when an obligation should be recognised.

The existing guidance requires a liability to be recognised when: (a) it is probable that an obligation exists; (b) it is probable that an outflow of resources will be required to settle that obligation; and (c) the obligation can be measured reliably. This guidance, when applied consistently, provides useful, predictive information about non-financial liabilities and the expected future cash flows, and is consistent with the recognition criteria in the Framework.

The proposed guidance might require a liability to be recognised even where there is little or no expectation that an outflow of resources will be necessary to extinguish the obligation. This will make it more difficult for users to predict future cash flows.

The proposed standard will also create a number of practical difficulties for preparers including, for example: (a) the need to recognise and measure non-financial liabilities when the final outcome is highly uncertain; (b) the need to obtain sufficient evidence on which to base judgments about whether an obligation exists; and (c) the impact of client/attorney privilege, which may restrict access to data in some jurisdictions. We believe that these practical difficulties will lead to greater diversity in practice.

The Board explained in the IASB staff paper issued on 7 April 2010 and accompanying webcasts that it believes the proposed recognition guidance will only rarely change the circumstances in which a liability is recognised. We note that the staff paper and the webcasts responded to feedback that the proposed standard may not be well understood. We believe this feedback suggests that preparers and users are confused by the proposed standard, and we remain concerned that the proposed approach will be complex to apply. We also note that the staff paper uses terms such as 'without merit', 'valid claim', and 'when resolved' that may be interpreted to suggest different recognition thresholds and therefore lead to divergent accounting. We believe that the proposed standard would change the circumstances in which a non-financial liability is recognised more often than the Board expects.

Given that the Board does not intend to change practice significantly, we do not believe it is appropriate to replace the existing guidance with new principles that are likely to be less well understood and lead to greater complexity and diversity in practice.

We acknowledge that there is diversity in practice in limited circumstances under the existing model around when a liability is recognised; for example, the accounting for the expected cash outflows where management anticipates settling litigation to avoid further legal costs but does not consider there is a present obligation. We believe that this diversity could be mitigated by enhancing the existing guidance rather than by issuing a new standard. We have included in Appendix B some suggestions for how this could be accomplished.

Measurement

We do not believe that the measurement principles for non-financial liabilities should be revised as proposed.

Financial statements provide helpful information about non-financial liabilities when obligations are measured at an amount that reflects the expected outflow of resources. We believe that the most relevant and appropriate measurement of an obligation is the best estimate of the amount management expects to pay to extinguish it, based on the expected manner of extinguishment.

The Exposure Draft proposes that: (a) a non-financial liability is measured using an expected value technique; (b) management considers including in the measurement of a non-financial liability an adjustment for risk; and (c) an obligation that management intends to fulfil using internal resources is measured at the amount the entity would pay a third-party contractor to fulfil the obligation on its behalf. We are concerned that these proposals will often mean that a liability is measured at an amount that does not reflect the expected outflow of resources. This will reduce the usefulness and transparency of the financial statements.

We do not believe that an expected value technique is always the most useful way to measure a non-financial liability. We believe that the existing guidance, which allows management to select the most appropriate technique to measure each obligation, results in more decision-useful information.

There are circumstances in which it is difficult or impracticable to apply a weighted average calculation reliably; for example, when it is not possible to identify the timing and amount of each potential outcome and related probability, or when the range of outcomes is very wide. When the potential outcome is binary, an expected value technique will generally lead to a measurement that does not reflect the best estimate of what management expects to pay to extinguish the obligation.

We agree that the measurement of a non-financial liability should, in some circumstances, reflect the risk of variability in the outcome. Any adjustment for the risk of variability in outcome should, however, reflect the expected manner of extinguishment. This is covered adequately in the existing standard, and we suggest that this guidance be retained.

We do not agree that a non-financial liability that will be fulfilled by using the entity's own resources should be measured at the amount the entity would pay a third party to fulfil the obligation on its behalf. The amount that a third party would charge includes a profit margin that will not be incurred when an obligation is fulfilled using internal resources. This approach would not reflect the expected outflow of resources required to extinguish the obligation and would not provide useful predictive information about future cash outflows.

The proposed approach would overstate a liability before it is extinguished and result in a gain in the period(s) in which it is extinguished. Recognising a gain on an internal transaction is inconsistent with other aspects of the IFRS accounting model. We believe that this accounting would reduce the transparency of the financial statements and would not report faithfully the financial results in the periods in which the liability is recognised and derecognised.

We also believe that the proposed approach is inconsistent with the measurement objective in paragraph 36A of the Exposure Draft. An entity would not rationally pay more than the amount management expects to incur based on the expected manner of extinguishment.

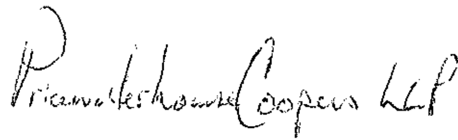
Costs

We acknowledge that it might be difficult to provide robust guidance regarding the costs that should be included in the measurement of a non-financial liability, but we do not believe that this difficulty is insurmountable. We believe that preparers and users of financial statements would find a principle about which costs to include in the measurement of a non-financial liability more useful than the proposed model.

We have included in Appendix B some suggestions for improving the existing standard. These include a suggestion that non-financial liabilities that will be settled using the entity's own resources should be measured on the basis of the direct costs of fulfilling the obligation. Costs in this context could be measured using a principle similar to that used for the recognition of non-financial assets, and would include costs that are directly attributable and necessary to the fulfilment of the obligation.

If you have questions regarding this letter please do not hesitate to contact Richard Keys, Global Chief Accountant (020 7212 4555), Tony de Bell (020 7213 5336) or Tom Quinn (020 7804 2196).

Yours faithfully



PricewaterhouseCoopers LLP

APPENDIX A: RESPONSES TO QUESTIONS

Question 1 – *Do you support the requirements proposed in paragraphs 36A–36F? If not, with which paragraphs do you disagree and why?*

We do not support the requirements proposed in paragraphs 36A-36F.

We consider that: (i) the measurement of a non-financial liability should reflect the manner in which management expects to extinguish that liability; and (ii) we disagree with the meaning assigned to paragraph 36B(a) in Appendix B to the Exposure Draft for the reasons described below. We suggest therefore that the measurement objective in paragraph 36A is amended and the guidance in Appendix B is revised. We also suggest that a principle for the inclusion of the costs of cancellation, transfer or fulfilment is added in paragraph 36D.

Our concerns about the measurement of non-financial liabilities using a third-party value (inclusive of profit) are explained in our covering letter and in our response to Question 2 below. We suggest that the measurement objective in paragraph 36A is amended to clarify that measurement is based on the expected cost to the entity of extinguishing the obligation as follows:

"An entity shall measure a non-financial liability at the present value at the end of the reporting period of the expected cost to the entity of extinguishing the present obligation."

We agree that the direct costs associated with cancelling, transferring or fulfilling an obligation should be included in the measurement of the obligation, but we believe that further clarification (i.e., what 'direct costs' comprise) would be helpful. We have described in our covering letter a principle that might be used to determine the costs to be included in the measurement of a non-financial liability.

Question 2 – *Do you support the proposal in paragraph B8? If not, why not?*

We do not support the proposal in paragraph B8, as we believe that non-financial liabilities should be measured at the present value of the expected cost to the entity of extinguishing the obligation, taking into account the manner in which management expects to extinguish the obligation. We believe that measurement of a non-financial liability should be based on third-party prices only where management intends to engage a third party. Our reasons for disagreeing with the Board's proposal are explained below.

1. Usefulness of information to users

We agree with the comment in paragraph BC20(b) that investors are interested in understanding the future cash flows of an entity; we therefore believe that the inclusion of a profit margin when fulfilment will be undertaken by the entity does not provide decision-useful information. We also concur with paragraph AV2(b) of the dissenting view that to record a liability at an amount greater than that which is expected to be paid creates inappropriate performance information both in the period when the liability is recorded and in the period in which it is extinguished.

2. Inconsistency with the measurement objective

We do not believe that the 'value of resources' measurement requirement is consistent with the measurement objective. Where management intends to fulfil an obligation using the entity's own resources, it would not rationally pay more than this cost to be relieved of the obligation. Markets are not always efficient, and there are sometimes benefits from undertaking the fulfilment internally where those benefits could not be accessed externally. Management might therefore decide to fulfil an obligation using its own resources even though this appears more expensive than paying a third party to fulfil the obligation on its behalf. For example, companies often use their own staff to undertake or manage environmental rectification, as this defers or reduces redundancy costs.

3. Inconsistency with other aspects of the IFRS model

Many entities fulfil non-financial liabilities, at least partially, using internal resources. The proposed model would require such entities to recognise a liability in excess of the cost to be incurred and then to record a gain on fulfilment of the obligation. Inherent in the definition of income (gain) set out in paragraph 70(a) of the Framework is an inflow of economic benefit. Fulfilling an obligation using internal resources should not result in a gain when the activity does not give rise to an inflow of economic benefit.

4. Inconsistency with the model for asset accounting

The proposed model is not consistent with the accounting for costs required by non-financial asset standards (IAS 2, IAS 16 and IAS 38). Assets are recognised under these standards based on the cost to the entity. Items purchased from third parties are measured inclusive of the third-party profit margin, whereas assets constructed internally do not reflect a profit margin. Gains do not arise on the recognition of internally generated assets. We do not believe that gains should arise from derecognising a liability when an obligation is fulfilled.

5. The importance of management intentions

We believe that management's intentions are relevant in determining how non-financial liabilities are measured and provide the most relevant information about expected future cash flows. Management's intention is used in a number of other standards to determine the accounting treatment, including: IAS 12, in respect of the expected manner of recovery/settlement of assets/liabilities; IAS 39, in respect of hedging of highly probable forecast transactions; IFRS 5, in respect of assets held for sale; and the business model approach required by IFRS 9. We suggest that an obligation should be measured at price a third-party contractor would charge only when management intends that a third party will be used.

Question 3 – *Do you support the exception in paragraph B9? If not, what would you propose instead and why?*

We do not support the proposed exception in paragraph B9. We believe that onerous contracts are non-financial liabilities and that all of the guidance for non-financial liabilities, irrespective of their nature, should be included in one standard and subject to similar recognition and measurement principles. Including the guidance in different standards could lead to diversity in practice. We therefore disagree with the proposed scope exclusion.

We agree with the Board that these obligations should be measured at the expected cost to fulfil the entity's contractual obligations, but we believe, as we have explained above, that this principle should be applied to all non-financial liabilities.

OTHER COMMENTS – Contingent assets

Contingent assets are covered by the existing standard but there is no equivalent guidance in the proposed standard. We understand that these items are assets or potential assets and not non-financial liabilities, but we are concerned that removing the existing guidance without replacement will increase diversity in practice.

We suggest, for the reasons described in our covering letter, that the existing standard, including the guidance for contingent assets, is retained and perhaps clarified. The accounting treatment of these items could then be more fully considered in the future. If the Board decides to proceed with the proposed standard, we suggest that consequential amendments are made to the relevant asset standards to provide guidance in this area.

APPENDIX B: PROPOSED LIMITED AMENDMENTS TO EXISTING IAS 37

If the Board agrees to make more limited amendments to the existing standard as we have suggested in our covering letter, we recommend that the following improvements be considered:

1. Measurement principle

Paragraphs 36 and 37 of IAS 37 require provisions to be measured at 'the best estimate of the expenditure required to settle the present obligation... or transfer it to a third party'. This is typically interpreted to require that a provision is measured at the cost to the entity of fulfilling the obligation. However, the word 'settle' is not defined, and it is not clear whether settlement and transfer are measurement alternatives.

The measurement objective could be clarified by amending the existing standard to provide a principle that a non-financial liability is measured at the expected outflow of resources required to fulfil, cancel or transfer the obligation, based on management's expectations of the manner in which the obligation will be extinguished. When management expects to fulfil the obligation internally, the cost of fulfilment should reflect the present value of the internal cost to the entity of fulfilling the obligation. When management expects to fulfil the obligation using third-party services, measurement should reflect the present value of the cost to the entity of purchasing the services required to cancel, transfer or fulfil the obligation.

2. Costs to fulfil

A principle that a non-financial liability is measured at the expected cost to fulfil, cancel or transfer the obligation should be supplemented by a principle for determining 'cost'. There is currently diversity in the way the costs of fulfilling a present obligation are measured. Some entities include the direct and incremental costs that would otherwise be avoided, while others include an allocation of indirect costs. We suggest that the measurement guidance in the existing standard is clarified to require that the expected outflow of resources necessary to fulfil, cancel or transfer an obligation includes only the direct costs that management expects will be necessarily incurred to extinguish that obligation.

Direct costs might include the compensation and benefits for employees who devote a significant amount of time to fulfilling the obligation and the cost of the materials used. They might also, in limited circumstances, include the legal costs necessary to settle, transfer or fulfil an obligation. Legal costs that management expects to incur to defend litigation are not necessarily incurred to extinguish an obligation and should be recognised as incurred.

3. Recognition of liabilities in litigation

There is some diversity in the application of the existing standard around whether a provision is recorded when management expects to settle litigation despite believing there is no present legal obligation. We suggest that the principle is clarified so it is clear that a liability for litigation is not recognised unless there is a present obligation. A liability is not recognised based on an expectation that the litigation will be settled when there is no present obligation.

It would also be helpful to delete the word 'rare' from paragraphs 15 and 16 of IAS 37. We do not believe that this situation is uncommon. The indicators in paragraph 14 of the draft IFRS are helpful and would assist preparers to reach conclusions about whether a present obligation exists. We suggest that these indicators be incorporated into the existing standard.

4. Onerous contracts

There is some diversity in the application of paragraphs 63 and 66 of IAS 37 and in the way onerous contracts are distinguished from future operating losses, particularly in connection with executory contracts. We believe that clarification of the principles in the existing standard would help to eliminate this diversity.
We have explained in our response to Question 3 in Appendix A that we disagree with the Board's proposal to exclude the measurement of certain onerous contracts from the scope of the proposed standard. We suggest instead that some limited amendments to the existing standard might be helpful at this time to clarify the principles. We have described these amendments below. A more fundamental review of the accounting for onerous contracts might be considered in the future.

The current standard defines an onerous contract as 'a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.' The current standard does not, however, include guidance on the unit of account for the recognition and measurement of onerous contracts or specify the accounting when an entity's actions cause a contract to become onerous. This causes potential diversity in the recognition of onerous contract liabilities. 'Unavoidable costs' and 'economic benefits' are also not defined, which may lead to diversity in measurement.

a) *Unit of account* - The existing standard does not include a principle to determine whether the onerous contract guidance should be applied to a contract as a whole, to individual obligations or to unsatisfied portions of obligations. For example, it is unclear whether the costs associated with vacant space in a partially occupied leased building should be recognised as an onerous contract. It is also unclear whether a profitable contract becomes onerous when the costs to satisfy the remaining contractual obligations exceed the benefits remaining to be received.

b) *Result of own actions* - We agree with the Board that the liability for a contract that becomes onerous only as a result of an entity's own actions should be recognised when such actions occur. We also believe that a contract can become onerous when the entity is demonstrably committed to the actions that make it onerous. A lease contract, for example, might become onerous when an entity abandons a leased facility or otherwise irrevocably commits itself to the abandonment.

c) *Costs* - We suggest that the unavoidable costs used to measure an onerous contract are defined consistently with the costs used to measure other non-financial liabilities.

d) *Benefits* - We believe that the economic benefits that arise from a contract should be considered broadly and should include both direct and indirect benefits. There might be circumstances in which the economic benefits of a contract can only be fully understood by considering how the contract interrelates with other contracts. For example, an entity might enter into a contract that in isolation appears onerous, but otherwise provides other indirect benefits such as access to other profitable contracts, a consequential marketing benefit or a positive contribution against other costs that would have been incurred absent the contract.

e) *Examples* - We believe it might be useful to clarify the principle for determining the difference between an onerous contract and a future operating loss with some limited illustrative examples.

5. Risk adjusted discount rates

We support the clarification in B16 of the Exposure Draft that, where 'the risk adjustment for a liability is included by adjusting the discount rate, the adjusted discount rate is typically lower than a risk free rate', and we believe it would be helpful to include this clarification in the existing standard.

6. Restructuring liabilities

We agree with the Board's proposal to remove from the existing standard the guidance related to providing for employee costs in connection with a restructuring. We agree that all of the guidance related to employee benefit expense should be included in the employee benefits standard.

7. Discount rates

Paragraph 47 of the existing standard requires the discount rate to be a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the liability. It also requires that the discount rate should not reflect risks for which future cash flows estimates have been adjusted. The guidance is often interpreted to require that a risk-free pre-tax rate is required when cash flows have been adjusted to capture the risks specific to a liability, but we understand that there is some diversity in practice. We suggest that the principles for determining the discount rate are clarified in this area.