EFRAG

European Financial Reporting Advisory Group

19 May 2010
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sir/ Madam

IASB ED *Measurement of Liabilities in IAS 37 (limited re-exposure of proposed amendments to IAS 37)*

On behalf of the European Financial Reporting Advisory Group (EFRAG) I am writing to comment on the IASB Exposure Draft *Measurement of Liabilities in IAS 37 (limited re-exposure of proposed amendments to IAS 37)* ('the ED'), which was issued in January 2010. This letter is submitted in EFRAG's capacity of contributing to IASB's due process and does not necessarily indicate the conclusions that would have been reached in its capacity of advising the European Commission on endorsement of the definitive IFRS.

The ED sets out proposals for the measurement of liabilities in the scope of IAS 37. The ED proposes to measure liabilities at the amount that a reporting entity would rationally pay at the reporting date to be relieved of the obligation. This amount would be the lowest of the present value of the resources required to fulfil the obligation and the amounts to cancel or transfer the liability. Estimates of the value to fulfil would take into account the probability-weighted average of the outflows for the range of possible outcomes, the time value of money and the effect of uncertainty about the timing and amount of resources.

The main impacts of the proposals in the ED are to:

- disallow measurement of liabilities based on a "most likely outcome" approach which is currently widely used in practice for single liabilities;
- require the use of a value notion (instead of a cost notion) as basis for the measurement. In particular, an entity should, where there is a market, use an external contractor's price to determine the value of a liability fulfilled by undertaking a service; and where there is no market, add a profit margin to its internal costs to approximate a market price;

- require the inclusion of an explicit and systematic adjustment in excess of the expected present value of the outflows to reflect the risk that the actual outflows may differ from those expected.

EFRAG is disappointed that the IASB is not re-exposing the full Standard because the Board considered that decisions made in the re-deliberation process did not fundamentally change the proposals in the original 2005 Exposure Draft. EFRAG believes that the proposals introduce fundamental changes in the recognition and measurement of liabilities and have important consequences for other accounting issues. EFRAG also notes that many respondents to the original ED expressed concern about the original proposals. For that reason EFRAG believes that a full re-exposure of the document would have been appropriate. EFRAG also thinks that recognition and measurement are inextricably linked and it is somehow artificial to separate the two.

Therefore, EFRAG includes in a separate section of our comment letter (Appendix 1) its comments on proposals other than measurement objectives and requirements. Our main comments are:

- EFRAG believes that IASB should ensure that the existing IAS 37 treatment for warranties continues to apply until a new IFRS replacing IAS 18 comes into place;

- EFRAG disagrees with the removal of the "probability of outflows" recognition criterion without any proper debate on this aspect of the conceptual framework; and

- EFRAG is not persuaded that the guidance provided on conditions of uncertainty and sources of evidence in paragraphs 13 and following is sufficiently clear to ensure consistent application.

We appreciate that the IASB is keen on completing the project as it has been outstanding for a long period of time, but we think that constituents should be provided with an adequate opportunity to comment on the proposed changes to IAS 37.

We understand that the objective of the ED is to eliminate what are perceived to be divergent interpretations and practices of the measurement requirements in IAS 37. However, we are not persuaded that the application of the current measurement guidance in IAS 37 is a source of significant problems for preparers; nor does it create serious comparability issues to users of the financial statements.

EFRAG has some significant concerns with the proposals in the ED. Our detailed comments on the ED are set out in Appendix 2 to this letter, but to summarise:

- EFRAG believes that the measurement objective should be directed at providing decision-useful information to users of financial statements and that would best be achieved if measurement was based on the expected outflow of resources to settle the liability;

- EFRAG is concerned about the requirement to apply an expected value approach to all liabilities in scope. EFRAG believes that this model in many cases is unlikely to provide decision-useful information when applied to single liabilities. Also, EFRAG is concerned that the model is too complex and onerous for those liabilities where evidence of the distribution of outcomes is often unavailable;

- EFRAG is of the opinion that the measurement of liabilities in scope of the Standard should be based on cost and is opposed to a value notion. As a consequence, EFRAG disagrees that the value to fulfil a service obligation should always be based on contractors' prices when there is an available market for the services and with the requirement to include a profit margin for the obligor when value to fulfil is based on internal prices because there is no market available; and

- EFRAG does not agree with the requirement to add a systematic and explicit adjustment for risk in excess of the expected present value of the outflows to compensate for their potential variability. Also, it believes that the requirement to include an adjustment for the risk is unclear as to when and how it should be applied.

For the reasons described above, we do not support the measurement model proposed in the ED. We believe that a case has not been adequately made to justify how the proposed changes are likely to improve the decision-usefulness of financial information about liabilities. Accordingly, in our view, the proposals set out in the ED fail to satisfy the IASB's objective to improve the quality of financial reporting. In our view the project to improve IAS 37 should be abandoned in its current form and should restart from a clear and new agenda proposal. Nevertheless if the IASB wishes to proceed with the project, we strongly encourage the Board to re-expose the full Standard to promote a more fulsome debate of the issues,

If you would like to discuss our comments further, please do not hesitate to contact Filippo Poli or myself.

Yours sincerely

Françoise Flores

EFRAG, Chairman

Appendix 1

EFRAG's comments on due process

EFRAG disagrees with the IASB's decision to re-expose only the limited guidance on measurement and to seek comments only on selected parts of it.

1 EFRAG notes that the original ED was issued almost 5 years ago. In this period, there have been significant developments in IFRS and in the notion of a liability and how they should be recognised and measured. Many of the associated issues are very complex and the IASB has itself required a considerable amount of time to re-deliberate these issues and reach tentative conclusions. Also a number of new entities have adopted IFRS since then and EFRAG believes that these constituents should be allowed to express their views on such an important topic.

2 Some proposals in the original ED raised widespread concern among constituents. IASB argues that it considered the criticisms and has adequately explained its conclusions to constituents. EFRAG does not believe that the IASB has adequately addressed those concerns.

3 IASB argued that there was no need to re-expose other aspects apart from measurement proposals because decisions taken in the re-deliberation phase did not fundamentally change the original proposals. EFRAG is not fully persuaded by the argument. The proposed new Standard deals with the recognition and measurement of liabilities that are not in scope of any other Standard. Since the original ED was issued, the IASB has taken some tentative decisions in its Revenue Recognition project that if confirmed will eventually impact the scope of the new Standard in relation to the accounting for warranty obligations. This in itself could be viewed as a change in scope which is worthy of discussion.

4 Finally, EFRAG notes that IASB acknowledged that some of the original proposals required additional guidance and clarification. For instance, IASB developed its thinking about how entities should address situations where it is uncertain if an obligation exists. This is a very crucial issue, especially following the removal of the "probability of outflows" recognition criterion, and EFRAG agrees that more detailed guidance was required. EFRAG believes that constituents should be given the opportunity to consider the proposals and guidance further to ensure that their concerns have been appropriately considered.

EFRAG's comment on scope (paragraphs 2 to 7 of the working draft)

EFRAG believes that IASB should ensure that the existing IAS 37 treatment for warranties continues to apply until a new IFRS replacing IAS 18 comes into place.

5 We are concerned that under the scope changes proposed in the ED the treatment of warranties in the interim period may not be clear and believe that there should be no ambiguity about the treatment of such a common and significant class of liabilities. Our understanding is that until the IAS 18 replacement is issued, measurement of warranties will remain in scope of IAS 37. For the avoidance of doubt it is our strong view that IASB should ensure that the existing IAS 37 treatment for warranties continues to apply and that the effective dates for the IAS 18 and IAS 37 replacement standards are aligned.

EFRAG's comments on the definition and recognition criteria (paragraphs 7 and 8 of the working draft)

EFRAG disagrees with the removal of the "probability of outflows" recognition criterion.

6 EFRAG does not support any major conflict with the Conceptual Framework. If such changes are considered appropriate, EFRAG thinks that they should be considered in the context of the Framework debate. Introducing major changes in the development of individual IFRS undermines the authority of the Conceptual Framework and creates the risk that changes that may be considered appropriate in particular circumstances will at some future date be extended to other circumstances without proper debate.

7 Conflict with the Framework is not the only reason why EFRAG disagrees with the proposal. EFRAG believes that information is decision-useful when it helps to predict the future outflows of the entity as explained more in detail in paragraph 21 below. Removing the "probability of outflows" recognition criterion results in the recognition of liabilities that may be very unlikely to result in the future outflows of resources and we do not believe that it improves the quality of financial reporting.

EFRAG's comments on constructive obligations (paragraph 12 of the working draft)

EFRAG believes that the notion of constructive obligation may be inconsistent with the criteria to recognise a liability.

8 EFRAG notes the definition of a present obligation in paragraph 18 of the working draft and the characteristics of constructive obligations in paragraph 12 of the working draft may be perceived as inconsistent. Paragraph 18 states that if an entity can avoid an obligation through its future actions it does not have a present obligation. Paragraph 10 of the working draft adds that the entity does not have a present obligation even if the only way to avoid it is to terminate its operations.

9 Based on paragraph 10 of the working draft economic compulsion does not in itself create a present obligation. However, EFRAG notes that the only reasons to comply with a past practice or a public statement are either because these can be legally enforced; or because the entity has no realistic alternative to comply if it wants to avoid serious adverse consequences. In these cases EFRAG believes that the entity has a constructive obligation and it should recognise a liability as such.

EFRAG's comments on uncertainty about the existence of an obligation (paragraphs 13 to 16 of the working draft)

EFRAG is not persuaded that the guidance provided on conditions of uncertainty and sources of evidence in paragraphs 13 and following is sufficiently clear to ensure consistent application.

10 EFRAG understands that the IASB was concerned about the existence of an explicit probability threshold. When a 'bright line' test is applied as a recognition criterion, a liability with a binary nature (e.g., a litigation where an entity may either win or lose) is not recognised when the negative outcome has a 49% probability and fully recognised when it has a 51% probability to occur.

11 When applying the recognition criteria in the current IAS 37, the practice that appears to have developed is that entities tend to establish a provision whenever an outflow is deemed probable, although there may be uncertainty about the existence of a present obligation; and not to recognise a provision when an outflow is deemed unlikely, regardless of whether the obligation exists.

12 In other words entities use the probability of outflows as a necessary and sufficient condition to recognise a liability. Although it is true that the existence of an obligation will often result in an outflow of resources and conversely, that an entity often incurs an outflow only if it determines that it has an obligation, the two notions are conceptually separate.

13 EFRAG is however concerned about the practical implications of the new proposals in dealing with non-contractual obligations such as litigations. The elimination of the "probability of outflows" recognition criterion (that EFRAG disagrees with, as mentioned in paragraph 6 above) puts all the emphasis on assessing if an obligation exists. Sometimes the degree of uncertainty is very high; even the decision to settle may not be the consequence of the fact that the entity has reached a clear conclusion on the existence of the obligation which thus may never be established.

14 EFRAG is not persuaded that the guidance provided on conditions of uncertainty and sources of evidence in paragraphs 13 of the working draft and following is sufficiently clear to ensure consistent application. EFRAG notes that this lack of guidance on the existence of an obligation could lead to the following:

(a) Some entities will not recognise a liability until the date a legal case settles, because they concluded that they had a good defence and hence no obligation; or

(b) Some entities will perform complex calculations involving remotely probable outflows because they have concluded that the Court may decide that they have an obligation.

15 In this context a staff paper on *Recognising liabilities arising from Lawsuits* was posted on the IASB website in April 2010. The purpose of the paper is to explain how the new recognition criteria would apply to liabilities arising from lawsuits and why the IASB is changing the criteria. As noted above this is an area where application of the new criteria is likely to be complex so EFRAG encourages the IASB to include this guidance in any final Standard to illustrate how the principles should be applied. Even taking into account this staff paper EFRAG still believes that further guidance is desirable, otherwise the likely consequences may be different from those the IASB is anticipating.

16 For example there are many circumstances when an entity is uncertain about the existence of a liability, but is aware that it will incur costs either to defend itself or to settle out of court. Indeed settlements are very common in those jurisdictions which have contingent fee arrangements and no cost awards. We do not therefore agree with the staff paper (paragraph 13) that the practice of settling such cases necessarily provides any evidence as to the validity of such claims. In those cases however where an entity has determined that some outflows of resources arising from the dispute are unavoidable, it is arguable that this might constitute an obligation. EFRAG believes therefore that the IASB should clarify whether in fact as an alternative a constructive obligation can arise in these cases, either from the entity's practice in settling such disputes, or indeed the past practice in such cases or in such jurisdictions.

17 As the staff paper makes clear the IASB believes that the proposals will lead to recognition of fewer and not more liabilities for litigation. In paragraph 17 of the staff paper it is claimed that the proposals will align with the treatment in IFRS 3 in the context of a business combination. In practice however we believe that when applying such requirements most entities will view the existence of unavoidable outflows of the type discussed in paragraph 16 above as constituting a present obligation.

18 We also note that in paragraph 24 of the Staff paper the IASB has explained why in its view the proposals provide more useful information to capital providers – emphasising the need to take account of uncertainty. EFRAG does not believe that however that this explains how the focus on the present obligation – rather than the unavoidable outflows – brings more useful information to users. If cash flows are fairly certain and arise as a consequence of the entity's past activities (as in the example of litigation which the entity expects to settle even in the absence of a strict liability) then EFRAG believes that this degree of certainty is best reflected in measurement rather than disclosure.

EFRAG's comments on contingent assets

EFRAG encourages the IASB to provide clarification for the treatment of contingent assets.

19 The existing IAS 37 provides guidance for the treatment of contingent assets which has been eliminated in the IAS 37 replacement. Contingent assets are a long-established notion in IFRS and lack of clarification might lead entities to assume that the proposed recognition and measurement criteria also apply to contingent assets. EFRAG encourages the IASB to provide clarification on the treatment of contingent assets for financial reporting purposes.

Appendix 2

EFRAG's responses to the questions in the ED

> **Question 1 – Overall requirements**
>
> The proposed measurement requirements are set out in paragraphs 36A-36F. Paragraphs BC2-BC11 of the accompanying 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?

EFRAG's response to Question 1

> **EFRAG believes that the measurement objective should be directed at providing decision-useful information for users of financial statements and that would be best achieved if measurement was based on the expected outflow of resources to settle the liability.**
>
> **EFRAG disagrees with some aspects of the measurement guidance. Question 2 refers only to some parts of the guidance; therefore EFRAG's comments on the other aspects are included in its response to question 1. EFRAG disagrees more particularly with the requirement that an expected value approach should always be used to determine the value to fulfil. We also have concerns about the requirement to include a risk margin in the measurement of the liability.**

Measurement objective

20 EFRAG notes that an entity has different alternatives when confronted with an obligation:

(a) it may cancel the obligation by paying cash to the party it is obliged to;

(b) it may transfer the obligation to a third party that is willing to accept it in exchange for cash. This could be done after the obligation has arisen or on a preventive basis when an entity insures itself against a business risk;

(c) it may engage a third party to fulfil the obligation on its behalf; or

(d) it may fulfil the obligation on its own.

It is reasonable to assume that in many cases an entity will look at the different alternatives to identify the least costly one. However EFRAG disagrees with the IASB's view that this is always the most rational choice. An entity may accept incurring a higher outflow of resources for different reasons, such as preserving its image, enhancing relationships with clients or keeping control of its technology.

21 The IASB states that the objective is to measure the liability at the end of the reporting period and to depict the measurement uncertainties that exist at that date. EFRAG disagrees with this position; it believes that the objective of measurement should be directed at providing decision-useful information, and that objective is achieved if the measurement aims to predict the future outflow of resources that the entity will incur to be relieved of the obligation based on the conditions existing at the reporting date.

22 Applying the requirements in paragraph 36B and B8 does not result in entities measuring liabilities based on the outflow of resources expected to settle the liability. This measurement is closer to a fair value notion. EFRAG accepts that this is relevant for an acquirer in the context of a business combination but is not persuaded that it should be the objective outside that context.

<u>Guidance provided in Appendix B</u>

23 EFRAG notes that the IASB raises only a question in relation to the requirements in paragraph B8. EFRAG disagrees with other parts of Appendix B, therefore in its response to question 1 EFRAG explains its concerns about the use of expected value and the inclusion of an adjustment for risk.

<u>Applying expected value</u>

24 EFRAG is aware that IASB does not intend to revisit the requirement to base measurement on expected values rather than on most likely outcome. However, EFRAG believes that the objective, the method and the elements of the calculation are linked. It is therefore necessary to comment on all aspects to present a coherent view.

25 EFRAG believes that the requirement to always use expected value, paired with the removal of "probability of outflows" recognition criterion, may not result in decision-useful information. This will particularly be the case when an entity faces an obligation where one of the possible outcomes is a low-probability, high-outflow scenario.

26 Assume that an entity estimates that there is a 99% probability to pay 1.000 and a 1% probability to pay 100.000. If the objective is to provide information on the future outflows, the outcome of 1.000 should be used as a measurement basis because it is overwhelmingly likely to occur. EFRAG does not think that using the expected value of 1.990 conveys decision-useful information. In EFRAG's view, providing suitable disclosure about low probability events is more useful than trying to reflect information about such uncertainty by adjusting the measurement of the liability.

27 As noted above, EFRAG believes that the measurement of a liability should provide users with information on the future outflows. Therefore, EFRAG believes that the entity should use the individual most likely outcome when this outcome has a high likelihood to occur. We acknowledge that in some cases the individual most likely outcome is not an appropriate basis because of uncertainty but we believe that the IASB should provide pragmatic solutions for these cases (as in the existing IAS 37) instead of advocating a rigorous expected value model. A more pragmatic alternative would be to make the assumption that outcomes have a normal distribution unless there is reliable evidence to indicate the contrary.

28 If there is evidence that the outcomes do not follow a normal distribution, the entity could apply an expected value approach. However, this requires that the entity has access to reliable evidence to support the calculation. In the absence of that, the entity could use the mid-point of the range in the distribution.

29 Furthermore, we are not convinced that the IASB has adequately considered the cost-benefit constraint in the Framework in imposing the requirement to use a probability-weighted average of the outflows for the possible outcomes.

30 EFRAG believes that allocating probabilities to multiple future scenarios often is complex and requires the use of a substantial degree of judgement. Whilst in dealing with portfolio liabilities entities can often rely on past experience with similar items to form an expectation, this does not apply for single liabilities.

31 In the case of single liabilities, entities may have little information about the likelihood of different scenarios if these liabilities are unique or of an unprecedented nature, as may be the case with legal claims. External advisors may also be reluctant to indicate precise probabilities and related outflows.

32 Hence EFRAG believes that in those cases the degree of judgement involved is such that using expected value would undermine reliability. Again this would apply particularly in cases of low probability but with a potential high cash outflow.

33 Guidance provided in B4 does not alleviate that concern. Rather, it brings uncertainty in how the measurement should be implemented. EFRAG thinks that paragraphs B3 and B4 may provide conflicting guidance and confuse preparers. Whilst B4 seems to address the concern that a rigorous expected value approach is unduly onerous, it is unclear what is meant by capturing the array of possible outcomes. Does it mean that an entity is allowed to ignore scenarios whose probability is lower than a certain threshold? Or does it mean that an entity can sub-group scenarios with outflows close in value?

34 EFRAG notes that based on paragraph B4 divergent practices may still emerge and undermine any intention to eliminate a perceived vagueness of the measurement requirements and improve their consistent application.

Including a risk adjustment

35 EFRAG disagrees with the requirement to include a risk adjustment in the measurement of liabilities systematically and in all circumstances. EFRAG accepts the notion in existing IAS 37 that uncertainty should be considered when estimating the future outflows; an entity should employ caution in making judgments and perform an unbiased assessment of the probability of each possible outcome. However, EFRAG does not agree with the requirement to add a systematic and explicit adjustment for risk in excess of the expected present value of the outflows to compensate for their potential variability in outcomes in all circumstances.

36 EFRAG believes that an entity would be willing to pay a price to be relieved of risk only to be protected from a possible outcome with a potentially very high outflow. EFRAG does not believe that the measurement should reflect the risk that expectations may be incorrect, and believes that users can receive adequate information about the risk inherent in the measurement from disclosure of the range of possible outcomes or highest exposure.

37 Finally, EFRAG notes that paragraph B15 does not always require the risk adjustment, but it does not indicate what circumstances would justify it and it does not provide guidance how to determine it. EFRAG is also concerned that entities may not have external evidence to assess the adjustment reliably in the absence of an external market where the liability can be transferred. There is a risk that the lack of guidance could result in generic unsupported adjustments or in significant diversity in practice.

Interactions with other current projects

38 EFRAG is aware that the IASB is currently working on other projects that deal with the measurement of uncertain liabilities such as Leases and Insurance Contracts. Some argue that liabilities in scope of IAS 37 and these liabilities are similar in nature and therefore their measurement should be based on the same principles.

39 EFRAG disagrees with that view.Liabilities arising from contracts with customers are quite different in nature from liabilities in scope of IAS 37 and their measurement may impact revenue recognition. Moreover, these liabilities are more frequently portfolio-type liabilities and for instance entities with insurance activities typically have access to more data (historical trends, actuarial projections) than industrial entities dealing with non-financial liabilities in scope of IAS 37.

40 As a consequence EFRAG considers that its conclusions on the proposals in the ED should not necessarily apply to liabilities that are outside the scope of IAS 37.

Question 2 – Obligations fulfilled by undertaking services

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 a 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?

EFRAG's response to Question 2

In relation to paragraph B8 EFRAG has the following concerns:

a) EFRAG does not agree with the requirement to add a profit margin when the value to fulfil a service obligation is measured based on internal inputs;

b) EFRAG believes that the requirement to use an observable market price is not consistent with the requirement to measure the liability at the amount that an entity would rationally pay.

41 EFRAG supports measuring liabilities based on the future outflow of resources and applying a cost basis. As a consequence it disagrees that entities should include a margin when they measure the value to fulfil based on internal inputs because there is no market for the service. A return on the resources used does not represent a future outflow.

42 EFRAG shares the concerns expressed in the alternative view by the dissenting IASB members. To include a hypothetical margin in the measurement of a liability reduces the profit at inception and release a profit when the liability is settled. EFRAG agrees with the view that such accounting creates inappropriate performance information.

43 Inclusion of a profit margin in the measurement of a performance obligation appears appropriate to the extent that this arises from a transaction with a customer. In this case the entity negotiated a price inclusive of a profit margin for the provision of the services, and it should recognise it when it fulfils the obligation. However, EFRAG notes that all liabilities that are directly linked to a sale transaction are meant to be outside the scope of the IAS 37 replacement Standard .

44 Some obligations arise in connection with the revenue-generating activity of the entity, like asset decommissioning. However, there is no direct link between the revenue-generating activity and the obligation. The counterparty of the obligation is not the counterparty of the sale transaction, and the settlement date may be very distant from the sale transaction. In other cases the obligation is not related at all to a sale transaction, such as an obligation arising from damages to third parties. So EFRAG does not think that the same rationale of paragraph 44 applies.

45 To follow the IASB proposal implies that entities could account for a profit for activities that do not involve any exchange with customers. For instance, IAS 16 requires including in the cost of an item of property, plant and equipment the costs of dismantling and removing the item and restoring the site on which it is located. If the measurement of the decommissioning and restoration liability includes a profit margin, the carrying amount of the asset will embed an unearned profit. EFRAG does not think that this is appropriate.

46 EFRAG also thinks that inclusion of a margin may not reflect the decision-making process of the entity. Normally when an entity has access to internal resources to perform the service it will compare its internal costs to the price asked by external contractors.

47 Some argue that an entity would include a return on the use of its resources when calculating the cost. This may be the case only if internal resources are already fully occupied and an entity has to forfeit revenue-generating activities to perform the service. When this is not the case, EFRAG is not persuaded that it will include a return in the assessment of the cost. An entity would not generally be willing to pay a profit to a third party if the use of its available internal resources has a lower cost.

48 EFRAG understands that the IASB supports the use of a market price, when available, because it believes that reference to a market is more objective than an entity's internal costing. Using a cost notion would require having detailed guidance on which types of costs should be included. The IASB believes that in most cases there is a market, so that entities will rarely be required to measure the liability in accordance with paragraph B8(b).

49 EFRAG however is not persuaded by the argument. First of all, the notion of market may be vague: there may be cases where there are subcontractors of similar services but because of technology, know-how and quality of service the entity would not engage them to perform the service; there may be cases when subcontractors are only available outside the country or the region where the entity operates. EFRAG is concerned that entities may use a different notion of what constitutes a 'market'.

50 EFRAG also challenges the IASB's view that there is a market for most types of services. EFRAG has not seen sufficient evidence that this will be the case and believes that in many cases entities will have to apply the measurement in paragraph B8(b). EFRAG supports measuring the liabilities at the production cost that a service provider would use to measure its cost of inventories in accordance with IAS 2; we support the view expressed in the BC20 of the ED and believe that this measurement is consistent with the requirement in B8(b).

51 EFRAG stated its view on what the measurement objective should be in paragraph 19. However, if the IASB confirms its preference for the measurement objective expressed in the ED. EFRAG would like to point out that there seems to be contradiction between paragraph 36B and paragraph B8. Paragraph 36B requires the use of the lowest available amount, while paragraph B8 obliges entity to use first an external market price (if available) to measure the value to fulfil a service obligation. Only if there is no market, the entity can calculate the value to fulfil based on its internal costs plus a margin. If the intention of the IASB is to always require the use of the lowest possible amount, it follows that the entity should measure the value to fulfil at the lower of the amounts in letter a) and b) of paragraph B8 (external market price and expected costs plus a margin).

Question 3 – Exception for onerous sales contracts

> Paragraph B9 of Appendix B proposes a limited exception for onerous contracts arising from transactions within the scope of IAS 18 *Revenue* and 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 supply them on its behalf. Paragraphs BC23-BC27 of the Basis for Conclusion explain the reason for this exception.
>
> Do you support the exception? If not, what would you propose instead?

EFRAG's response to Question 3

> **EFRAG agrees with the IASB proposal.**

52 As noted in previous paragraphs, EFRAG believes that liabilities should be measured based on the future outflows. It therefore agrees with the proposed measurement for onerous contracts. EFRAG's view is that as an entity fulfils the obligation incurred under an onerous contract, it would be counterintuitive to recognise an accounting gain.

53 EFRAG also agrees that it is not advisable to introduce a change in practice that could be potentially reversed when the IASB will issue the new Standards replacing IAS 18 and IFRS 4.

54 Also, the requirement to measure onerous contracts based on the excess of costs over its economic benefits is consistent with the requirement in IAS 11 *Construction Contracts.* Paragraph 36 states that "when it is probable that total contract costs will exceed total contract revenue, the expected loss shall be recognised as an expense immediately". Although IAS 11 does not define the notion of loss, this is widely interpreted to equal the excess of costs over the revenue. Without the exception, measurement of onerous contracts arising from transactions under IAS 18 and IAS 11 would be different.