AMENDED COMMENT LETTER

Comments should be sent to commentletters@efrag.org by 7 May 2010

EFRAG originally issued its draft comment letter on the IASB ED *Measurement of Liabilities in IAS 37 (limited re-exposure of proposed amendments to IAS 37)* in February 2010.

After the IASB in February 2010 published in its website the working draft of the new Standard replacing IAS 37, EFRAG decided to expand and include additional comments on the proposed scope (paragraphs 13 and following in Appendix 1), constructive obligation (paragraphs 25 and following), and guidance on uncertainty in the existence of obligations (paragraphs 27 and following).

EFRAG has also added to its comments on the measurement of obligations fulfilled by undertaking a service (paragraphs 72 and following in Appendix 2).

These additions are included in the letter below as marked-up text.

xx month 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 inclusion of a profit margin in the measurement of a liability with a service component, when the measurement is based on the value to fulfil and there is no market for the service; and
- require the inclusion of an adjustment for risk in the measurement of a liability.

We note that the IASB has decided not to re-expose in full the original 2005 ED of proposed Amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and IAS 19 *Employee Benefits* because it considered that tentative decisions made in the re-deliberation process did not fundamentally change those proposals. The IASB decided to require comments only on the expanded measurement requirements. However, EFRAG disagrees with this decision because it believes that the proposals introduce fundamental changes in the recognition and measurement of liabilities and therefore 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 included in a separate section of the document (Appendix 1) its comments on proposals other than measurement objectives and requirements. Our main comments are:

- EFRAG believes that warranties should stay in the scope of the new IFRS replacing IAS 37 until a potential new IFRS replacing IAS 18 comes into place;
- EFRAG disagrees with the removal of the "probability of outflows" recognition criterion;

- 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 practices and interpretations 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 proposed model based on expected value, paired with the removal of the "probability of outflows" recognition criterion, as in many cases it is unlikely to provide decision-useful information. Additionally, the model may prove too complex to apply especially for single liabilities, where evidence of the distribution of outcomes will often be unavailable;

- EFRAG disagrees with the proposal that the value to fulfil the obligation should include an adjustment for the risk that the actual outflows may differ from expected outflows;

- EFRAG disagrees with the proposal that the value to fulfil a service obligation should include a profit margin when the measurement is based on internal costs.

For the reasons described above, we do not support the measurement model proposed in the ED. We believe that a case has not been 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 and for that reason should be abandoned.

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

Yours sincerely

Stig Enevoldsen

EFRAG, Chairman

Appendix 1

Introduction

1 In mid-February 2010, EFRAG issued its draft comment letter on the Exposure Draft Measurement of Liabilities in IAS 37. When the draft comment letter was issued, the full draft of the new Standard replacing IAS 37 was not yet available. EFRAG noted that it would possibly include comments on additional topics when the draft would become available.

2 The IASB posted the full working draft of the new Standard on February 19th. The full draft may be found at: http://www.iasb.org/NR/rdonlyres/3C00FC6B-F8E3-4826-82B4-3580989B31EA/0/IFRSLiabilitiesWorkingDraftFeb10.pdf

3 In March 2010 the IASB decided to extend the original comment deadline from April 12th to May 19th. Subsequent to this decision, EFRAG decided to extend its own comment deadline from March 19th to May 7th.

EFRAG's comments on due process

Background notes to EFRAG's constituents

~~1~~4 In June 2005, the IASB issued an Exposure Draft of proposed Amendments to IAS 37 Provisions, Contingent Liabilities and Contingent Assets and IAS 19 Employee Benefits ("the original ED"). The original ED suggested a number of fundamental changes to the way entities account for provisions.

~~2~~5 The original ED required recognition of a liability when an entity has a present obligation arising from a past event regardless of whether an outflow of resources was probable or not. It also stated that an entity has a liability when it has an unconditional obligation to stand ready to fulfil, although the amount to settle is contingent on a future event.

~~3~~6 In its comment letter dated 28 November 2005 EFRAG expressed its concern about the removal of the probability recognition criterion and disagreed that a stand-ready obligation as defined in the original ED created in itself a liability.

~~4~~7 The IASB began the re-deliberation process in February 2006 and revised some of the proposals in the original ED. The IASB decided to re-expose only measurement guidance and issued an Exposure Draft Measurement of Liabilities in IAS 37 in January 2010 ("the ED").

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.

~~5~~8 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, how it 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.

~~6~~9 EFRAG also notes that the measurement model in this project may become a reference for the measurement of other types of liabilities such as those arising from insurance contracts. EFRAG believes that because of its significant implications for other future projects, it would have been advisable to have an even more thorough debate than usual.

~~7~~10 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 these concerns.

~~8~~11 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.

~~9~~12 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)

Background notes to EFRAG constituents

13 Paragraph 2 of the working draft states that the new Standard is applicable to all liabilities apart from those that:

(a) Are not in the scope of another Standard; or

(b) Arise from an executory contract unless the contract is onerous.

14 Paragraph 3 includes a non-exhaustive list of liabilities that are addressed in other Standards.

15 EFRAG is concerned that the scope of the new Standard may not be sufficiently clear particularly in relation to product warranties. At present it is clear that they are within the scope of the current Standard. IAS 37 and the replacement Standard addresses all those liabilities that are not covered by another Standard or Interpretation. Our view is that existing treatment under the existing IAS 37 should continue until the Revenue Recognition project is finalised.

16 EFRAG is concerned that under the scope changes proposed in the ED the treatment of warranties in the interim period may not be clear. Our understanding is that until the IAS 18 replacement is issued, measurement of warranties will be within the scope of IAS 37. However, an alternative interpretation may be that paragraph 18 of the current IAS 18 applies also to warranties that could be viewed as a separate component of a sale transaction. In that case, the scope exception in paragraph 3(f) could apply immediately, and warranties will be scoped out from the IAS 37 replacement from its effective date.

17 EFRAG believes that there should be no ambiguity about the treatment of warranties which are a common and significant class of liabilities. 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)

Background notes to EFRAG constituents

18 The IASB confirmed the proposal that an entity should recognise a liability if, and only if, it has a present obligation and the liability can be reliably measured. This is a change from the current requirements.

19 In fact, the current IAS 37 requires that an entity recognises a liability if:

(a) it has a present obligation;

(b) it is probable that an outflow of resources will be required; and

(c) the liability can be measured reliably.

The "probability of outflows" recognition criterion in (b) has been removed. So if an entity does not expect to incur future outflows, this information in itself does not affect recognition.

~~10~~20 Many respondents disagreed with the proposal and argued that the omission of the "probability of outflows" recognition criterion created a conflict with paragraphs 83 and 91 of the Framework. The IASB rejected that argument.

~~11~~21 *The IASB noted that the criterion articulated in IAS 37 and the Framework is not related to determining whether a liability exists, and that liabilities should be identified using the liability definition. It also noted that once a liability has been identified the probability recognition criterion would in almost all cases be met because an outflow of resources would be probable.*

22 *The IASB also noted that a "more likely than not" threshold in the Framework would result in the flawed conclusion that a performance obligation arising from a guarantee, a warranty or similar transactions would not be recognised until a claim becomes probable.*

23 *Based on the proposals, an entity deals differently with different types of uncertainty:*

(a) If the uncertainty concerns the existence of an obligation, an entity must use its judgment to conclude if the obligation exists or not. See paragraphs 27 and following below for additional information;

~~(a)~~*(b) If the entity has concluded that it has an obligation but there is uncertainty about the likelihood of future outflows, the entity recognises a liability. Uncertainty about the likelihood of future outflows affects measurement – in extreme cases the measurement of a liability at the reporting date could be close to nil.*

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

24 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.

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

25 EFRAG notes the definition of a present obligation in paragraph 18 of the working draft and the notion of constructive obligation 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.

26 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)

Background notes to constituents

27 The working draft requires the recognition of a liability when an entity has a present obligation and it can measure the liability reliably. As mentioned above, a liability must be recognised although the likelihood of a future outflow is low.

28 There are cases where the existence of the obligation is uncertain. In that case, an entity must consider all available evidence and use judgment to conclude if the obligation exists or not. An entity that concludes that it has an obligation must recognise a liability. An entity that concludes that it does not have an obligation does not recognise a liability, but must provide disclosures.

29 An obligation exists when an entity has a duty or responsibility to perform, and there is a counterparty to which the entity is obliged. If an entity can avoid the obligation through its future actions, it does not have an obligation.

30 In most cases, obligations exist only if they are legally enforceable. In limited circumstances an entity may have an obligation (a so-called constructive obligation) that is not legally enforceable but nonetheless binds the entity to act or perform in a certain way.

31 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.

32 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.

33 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.

34 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 24 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.

35 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 outflow because they have concluded that the Court may decide that they have an obligation.

36 There are 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. For example settlements are very common in those jurisdictions which have contingent fee arrangements and no cost awards. EFRAG believes that the IASB should clarify whether 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. In those cases 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. Certainly it would be viewed as such by most entities when applying IFRS 3 requirements in a context of a business combination. In bringing the necessary supplementary clarifications, the IASB should explain how the focus on the present obligation – rather than the unavoidable outflows – brings more useful information to users.

Questions to constituents

37 Do constituents agree with the IASB proposal that when there is uncertainty management should assess whether an obligation exists without applying a probability threshold?

38 Do constituents believe that the principle and guidance on uncertainty in paragraphs 13 and following of the working draft is sufficient? If not, what type of additional guidance is needed?

39 Do constituents believe that an entity should recognise a provision in a scenario as the one presented in paragraph 36 above (where the entity is uncertain about the existence of an obligation but will incur unavoidable cost)?

40 What are constituents' views about constructive obligations?

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?

Background notes to EFRAG's constituents

~~12~~41 *The original ED proposed that an entity would measure a liability in its scope at the amount that it would rationally pay to be relieved of the obligation at the reporting date. For comparison purposes, the current version of IAS 37 requires measurement of a liability at "the best estimate of the expenditure required to settle the present obligation at the balance sheet date." Paragraph 37 clarifies that the best estimate is the amount that the entity would rationally pay to settle the obligation or to transfer it.*

~~13~~42 *The IASB noted that the measurement requirement in the current IAS 37 was ambiguous and gave rise to diverging applications. Some thought that it could be interpreted as leaving an accounting choice to the entity when the obligation could be either fulfilled or transferred. Others argued that when there is a choice, an entity would rationally choose the alternative that involves the lower outflow of resources.*

~~14~~43 *There was also uncertainty about the meaning of "best estimate". Some believe that it is the single most likely outcome while others believe that it is the weighted-average of all possible outcomes. Also, some entities include in the estimate only incremental costs, while others include all direct costs and even allocate indirect costs.*

~~15~~44 *Because of the above, the IASB deemed it necessary to clarify the measurement requirement. The ED proposes measurement based on the amount that an entity would rationally pay at the end of the reporting period to be relieved of the present obligation. Paragraph 36B details how to determine such an amount.*

~~16~~45 *Paragraph 36B requires measuring the liability at the lowest of the present value of the resources required to fulfil the obligation and the amount that the entity would have to pay to cancel and/or transfer the liability. In those frequent cases when the obligation can neither be cancelled nor transferred, the entity estimates the present value of the resources to fulfil the obligation. Appendix B of the ED explains how to determine that value.*

~~17~~46 *Appendix B requires entities to take into account the probability-weighted average of the present values of the expected outflows for the possible outcomes (the expected present value of the outflows), the time value of money and to include an adjustment for the risk that the actual outflows may differ from those expected.*

~~18~~47 Paragraph B3 requires entities to identify each possible outcome and make an unbiased estimate of the probability of each outcome. Paragraph B4 states that "even if there is evidence to support many outcomes, it is not always necessary to consider distributions of literally all possible outcomes using complex models and techniques. Rather, it should be possible to develop a limited number of discrete scenarios and probabilities that capture the array of possible outcomes".

~~19~~48 When the obligation cannot be fulfilled by undertaking a service, the entity includes in the outflows the payments to the counterparty and the associated costs.

~~20~~49 When the obligation can be fulfilled by undertaking a service, the entity applies the guidance in paragraph B8 which is detailed in paragraph 70 below.

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 to use an expected value approach to determine the value to fulfil the obligation; and the requirement to include a risk margin in the measurement of the liability.

Measurement objective

~~21~~50 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.

~~22~~51 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.

~~23~~52 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 this context.

Guidance provided in Appendix B

~~24~~53 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.

Applying expected value

~~25~~54 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.

~~26~~55 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.

~~27~~56 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.

~~28~~57 As observed above, EFRAG believes that the measurement 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. EFRAG acknowledges that in some cases the individual most likely outcome is not an appropriate basis because of uncertainty. However, instead of applying 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 the contrary.

~~29~~58 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.

~~30~~59 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.

~~31~~60 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.

~~32~~61 In this latter event, 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.

~~33~~62 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 high potential cash outflow.

~~34~~63 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?

~~35~~64 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

~~36~~65 EFRAG disagrees with the requirement to include a risk adjustment in the measurement of liabilities because this would be consistent with having the measurement reflect its own uncertainty. As indicated in paragraph 51, EFRAG disagrees that this should be the objective of measurement.

~~37~~66 EFRAG would question the appropriateness of a risk adjustment even within the conceptual model of the ED. EFRAG shares the concerns expressed in the alternative view of the dissenting IASB members. EFRAG thinks that it is not clear what this adjustment is intended to represent: if an entity performs an unbiased assessment of the probability of each possible outcome, it is unclear why it should add an additional adjustment on top of the expected value.

~~38~~67 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.

~~39~~68 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.

Questions to constituents

~~40~~69 What are constituents' views on the use of expected value?

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?

Background notes to EFRAG's constituents

~~41~~70 The ED specifically requires that when an obligation involves a service, the measurement of the liability should include not only the costs to fulfil the obligation but also a margin. When a market for the service exists, the entity refers to the price that a contractor would require to perform the service. When a market does not exist the entity includes the margin that it would require to undertake the service for a third party.

~~42~~71 The IASB members supporting this view argue that this is consistent with the overall measurement objective in the ED. If the liability is measured at the amount the entity would pay to get relieved of the obligation, this cannot be simply the cash outflows required to fulfil the obligation. An external party would be willing to assume the obligation (either as a purchaser or a contractor) only if it expects to make a profit out of the transaction, therefore the price that the entity would have to pay must necessarily include a profit margin.

EFRAG's response to Question 2

> **In relation to paragraph B8 EFRAG has the following concerns:**
>
> **a) EFRAG does not agree with the inclusion of a margin when the value to fulfil a service obligation is measured in the absence of a market;**
>
> **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.**

~~43~~72 EFRAG supports measuring liabilities based on the future outflow of resources and therefore, it disagrees that entities should include a margin when they measure the value to fulfil in the absence of a market. A return on the resources used does not represent a future outflow.

~~44~~73 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.

~~45~~74 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 not all liabilities in scope of IAS 37 can be directly linked to a sale transaction.

~~46~~75 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 74 applies.

~~47~~76 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.

~~48~~77 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.

~~49~~78 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.

79 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).

80 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 market.

81 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).

~~50~~82 EFRAG stated its view on what the measurement objective should be in paragraph 51. 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?

Background notes to EFRAG's constituents

~~51~~83 *The current version of IAS 37 defines an onerous contract as a contract in which the unavoidable costs of meeting the obligations exceed the economic benefits expected to be received under it. The proposals in the original ED do not change the definition.*

~~52~~84 *The IASB noted that under the proposals of the original ED there would be a difference between the criterion to identify an onerous contract and the criterion to measure it. It also noted that the difference would have practical implications only for contracts that oblige the entity to supply goods or services. This is because the proposed changes in the measurement requirements will affect only obligations to undertake services.*

~~53~~85 *It is possible that in future obligations arising from contract with customers will be excluded from the scope of IAS 37 and included in the scope of the Standards that will replace IAS 18 Revenue and IFRS 4 Insurance Contracts. It is also possible that these Standards will maintain the current practice to identify and measure onerous contracts on the same basis. The IASB decided to propose a limited exception that would be eliminated when (and if) onerous contracts arising from transactions with customers are excluded from the scope of IAS 37.*

EFRAG's response to Question 3

EFRAG agrees with the IASB proposal.

~~54~~86 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.

~~55~~87 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.

~~56~~88 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.

Questions to constituents

~~57~~89 Do you agree with the view expressed in relation to the proposed exception for the measurement of onerous contracts?

~~58~~90 Are there other aspects of the proposals in the ED that constituents believe it would be appropriate to address?