



RIC • c/o DRSC e.V. • Zimmerstr. 30 • 10969 Berlin

Telefon +49 (0)30 206412-12

Telefax +49 (0)30 206412-15

E-Mail info@drsc.de

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Berlin, 06 June 2007

Dear Sir David

Proposal for an amendment of IAS 37 in the course of the IASB's Annual Improvements Project 2007

In early 2007 the AIC discussed two issues related to the accounting of onerous contracts that were brought to us by our constituents. The first issue refers to the meaning of the term "economic benefits" in IAS 37.68 that is neither defined nor explained in the Standard. Furthermore, example 8 in Appendix C of IAS 37 does not give guidance on this issue. This implies the possibility of different accounting treatments in practice. The main question is the allocation of unavoidable costs to the related economic benefits. A narrow understanding of economic benefits could imply much higher provisions for onerous contracts than would be the case using the economically appropriate wider definition of these benefits. (Please refer to Appendix 1 for further details).

The second issue deals with the use of the singular form "contract" in IAS 37.66 that is somewhat contradictory to the appropriate understanding that the onerosity of several economically closely linked contracts should not be determined on a contract-by-contract basis. (Please refer to Appendix 2 for further details).

As a consequence, the AIC concluded that IAS 37 needs clarification in this respect. Since the IASB is currently working on an amendment of IAS 37 that also includes some changes to the accounting of onerous contracts, the issues could be integrated into this project.



As we have learned, however, that the IASB repeatedly affirmed its intention not to extend the scope of its current short-term-convergence deliberations on ED IAS 37, the AIC envisaged addressing the issues to the IFRIC in order to initiate an interpretation on IAS 37.66 and IAS 37.68. While the accounting for onerous contracts could potentially be affected by these issues there seems to be no sufficient evidence, however, that significant divergence in practice has emerged. Therefore, the AIC did not submit the issues to the IFRIC.

The AIC also discussed the subject with IASB staff responsible for IAS 37 who supported our view that IAS 37 would gain from a clarification of these aspects of accounting for onerous contracts. In light of these discussions the AIC believes that the issues could best be resolved by some minor amendments of IAS 37 that would well fit in the IASB's Annual Improvements Project 2007.

In summary, we would very much appreciate the inclusion of the issues into the Annual Improvements Project 2007 and would be glad to be of further assistance.

Kind regards

Stefan Schreiber
AIC Chairman



Appendix 1: “economic benefits” (IAS 37.68)

According to IAS 37.68 an onerous contract is defined 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. While the term “unavoidable cost” is explained in IAS 37.68, IAS 37 is silent on the “economic benefits”. Therefore, the view could be taken that it is currently in the discretion of the IFRS preparers to interpret this term very narrowly or very widely. This leads to a wide range of possible amounts for provisions for onerous contracts and implies that divergence in practice could potentially exist.

The expected economic benefit under a contract is the net present value of the future inflows related to the contract. The understanding of the term “economic benefit” is important because if this means only the benefits expected from the contract itself, in a narrow sense, then this would be likely to give rise to much higher provisions than if also benefits were included that are only indirectly related to the contract. If the latter view is adopted the question has to be answered how concrete the future inflows of the economic benefits have to be in order to be included in the assessment of the onerosity of a contract. In other words: Is it sufficient that economic benefits are just – more or less vaguely – expected?

This would imply that even the intentional engagement in a definitely loss-making contract would not necessarily require the recognition of a provision for onerous contracts if the entity’s management expects, for example, to open up a new market based on this contract. If the economic benefits derived from the contract and the net benefit of this market penetration are expected to be higher than the related costs no provision for onerous contracts would be recognised. However, if the intended opening of new markets fails in the future the recognition of a provision for the loss-making contract would be required.

Consider another example: A pharmacist operates a pharmacy in his own property and lets some rooms of this property to a doctor for his surgery. Both parties contractually agree on a rent that is by far below market price. No additional contractual agreements are made. The pharmacist’s rationale for engaging in such an agreement is that he expects to increase his sales due to the local closeness between the pharmacy and the surgery. According to the widest possible view no provision would be recognised if the sum out of the rent and the net inflows related to the expected increase of sales exceed the costs of the contract.

The AIC does not support the narrow understanding of economic benefits and assumes that a wider definition was intended by the IASB when developing IAS 37. In our view, this should be clarified and specified by adding some guidance into IAS 37.66 et seq. and/or into Appendix C of IAS 37.



Appendix 2: “contract” (IAS 37.66)

The second, closely related issue that should be resolved by the IASB in relation to onerous contracts refers to the allocation of costs and economic benefits between contracts in determining whether a contract is onerous. The use of the singular form “contract” in IAS 37.66 implies that each provision for onerous contracts refers to a single contract or transaction.

It can be questioned if this is also true in cases when several transactions are economically so closely related that it would contradict the economic substance of this group of transactions to determine for each underlying contract separately if it is onerous. Thus, the AIC holds the view that economically related contracts should not be separated but viewed together when assessing if a provision for onerous contracts has to be recognised.