DEUTSCHER STANDARDISIERUNGSRAT (DSR)

IDW
INSTITUT DER WIRTSCHAFTSPRÜFER

Sir David Tweedie
Chairman of the
International Accounting Standards Board
30 Cannon Street

London EC4M 6XH
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Düsseldorf, 22 May 2007

Dear Sir David

**Re: IASB Project "Liabilities" – Measurement of certain non-financial liabilities**

The German Accounting Standards Board (GASB) and the Accounting and Auditing Board of the IDW have recently discussed the measurement of non-financial liabilities under IFRS, when the reporting entity expects to fulfil the obligation itself in the future using its own human and material resources (e.g. obligations to clean up contaminations). The current IAS 37 is silent on this topic. Given the practical relevance and the divergent interpretations, an appropriate accounting treatment needs to be established.

Pursuant to IAS 37, paragraph 36 and paragraph 37, the amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the balance sheet date. The best estimate of the expenditure required to settle the present obligation is the amount that an entity would rationally pay to settle the obligation at the balance sheet date or to transfer it to a third party at that time. The standard does not provide guidance regarding the types of costs to be included in the measurement of a provision, when the entity intends or is compelled to fulfil the obligation itself in the future using its own human and material resources and there is no contractual or market evidence that can be used to determine the settlement or transfer amount at the balance sheet date. Different views exist as to whether to include only incremental costs or to include incremental and other costs that can be reasonably allocated to the settlement of the provision.

The two views on this issue can be described in more detail as follows:

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**View 1 ("Incremental Costs Approach"):**

Those who support this view point out that the accrual of future operating costs is prohibited (IAS 37, paragraph 18). Hence, only incremental costs that are related directly to the settlement of a provision should be included in the measurement of the provision. It is argued that, since incremental costs are those in addition to normal operating expenses, costs that are not incremental should not be included in the measurement of a provision, even if there is a reasonable basis for allocating a portion of these costs to the settlement of the provision. Although this principle applies to both external and internal costs, in practice internal costs often are not incremental and therefore normally would not be included in the measurement.

To underpin this interpretation one could cite the following applications of the measurement rules of current IAS 37:

- The definition of 'onerous contracts' refers to unavoidable costs, which can be interpreted as incremental costs (IAS 37, paragraph 10 and paragraph 68).
- A restructuring provision shall include only the direct expenditures arising from the restructuring, which are necessarily entailed by the restructuring and not associated with the ongoing activities of the entity (IAS 37, paragraph 80).

We understand that accounting literature generally supports this view.

**View 2 ("Full Costs Approach"):**

Proponents of the other view contend that all costs incurred in the settlement of an obligation should be included in the measurement of the provision. This includes costs that can be reasonably allocated to the settlement of the obligation. In their opinion, the prohibition of accrual of future operating costs according to IAS 37, paragraph 18, refers to recognition, not to measurement. The measurement concept is set out mainly in IAS 37, paragraph 36 and paragraph 37. Accordingly, provisions are measured based on what an entity rationally would pay to settle or transfer the obligation at the balance sheet date. This implies the notion that

- the entity settles the obligation with the counterparty by direct agreement, i.e. the entity pays the counterparty to release the entity from its obligation, or
- the entity transfers the continuing obligation to a third party, i.e. the entity pays a third party to assume its obligation.

In the latter case, the third party normally would demand compensation for all attributable variable and fixed costs (apart from the profit margin). In the former case, a rational counterparty would consider the possible transfer price in negotiating the settlement, thereby including all attributable variable and fixed costs as well. Therefore, in neither case is the measurement limited to incremental costs. Consequently, when the entity expects to fulfil the obligation itself in the future using its own resources, it would not be appropriate to include only incremental costs in measuring the provision.

According to the IASB Update, September 2006, the Board affirmed its understanding that the existing IAS 37 measurement principle is based on a current settlement notion, but conceded that many respondents to ED IAS 37 did not share its understanding. Rather they understand the IAS 37 measurement principle to be an ultimate settlement notion, i.e. the amount estimated to be required to extinguish the obligation in the future. In our view, the Standard is not unambiguous in this respect. Nevertheless, the measurement issue addressed in this letter needs clarification in either case.

The issue is widespread and has practical relevance. Moreover, as mentioned above, significantly divergent interpretations already exist in practice. Thus, we would have preferred the IFRIC add the item to its agenda. But, as the issue relates to the current IASB project "Liabilities", we appreciate that the IFRIC would be unlikely to place this issue on its agenda because the Board's project can be expected to resolve the issue in a shorter period than that required by IFRIC to complete its due process.

In the context of the current Project Update "Liabilities", i.e. based on the tentative conclusions to date, it appears that this issue would not be addressed in the amendments to IAS 37. Given the significance of the issue, we would appreciate detailed guidance concerning the appropriate accounting treatment in this area.

We would be pleased to answer any question that you may have or to discuss any aspect of this letter.

Yours sincerely

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President DSR

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Chief Executive Officer IDW