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Sir David Tweedie
Chairman of the
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30 Cannon Street
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Berlin, 19 April 2010

Dear David,

Exposure Draft ED/2010/1 Measurement of Liabilities in IAS 37: Limited re-exposure of proposed amendment to IAS 37

On behalf of the German Accounting Standards Board (GASB) I am writing to comment on the IASB Exposure Draft ED/2010/1 Measurement of Liabilities in IAS 37**:** Limited re-exposure of proposed amendment to IAS 37 (herein referred to as 'ED'). We appreciate the opportunity to comment on the Exposure Draft.

The GASB disagrees with the proposed measurement approach. In our opinion the measurement objective should reflect the way an entity intends to satisfy the obligation (management approach) rather than a measurement approach that considers alternatives that may be available but that the reporting entity has no intention to pursue. In our view measurement shall reflect reality, which should be based on the decisions management takes. These decisions need to be reflected in the financial statements of the entity to make them useful.

Entities normally fulfil their obligations. Therefore, we believe that the measurement requirements for liabilities should be based on a rebuttable presumption that the liability will be settled by fulfilment. Only if an entity has both, the intent and the possibility of cancelling or transferring the liability the entity would rebut the presumption and measure the liability based on the intended cancellation or transfer.

In contrast to the Board, we have a different understanding of how a fulfilment value of a service obligation should be determined. It seems to us that the IASB would like to introduce a measurement approach that is similar to a notion of fair value. Our approach is based on the expected costs of fulfilment. Hence, we would support a cost notion. Accordingly the GASB disagrees with the ED's proposals in paragraph B8 of Appendix B to either use a contractor's price, if there is a market for the service, or to include a profit margin, if there is no market for the service. A risk adjustment should only be taken into account to the extent outlined in the existing IAS 37.

We support the application of the expected value approach for large populations only and would advocate the individual most likely outcome approach for single obligations.

In our view the treatment of warranties under IFRS in the near future is unclear, because in our understanding warranties will be scoped out of the existing IAS 37 and scoped into the proposed discussion paper on revenue recognition. Both standards will be published at different times and the effective dates will also be different. The IASB should clarify how entities should account for warranties in the meantime.

We agree with the recognition criteria outlined in paragraphs 7 to 9 of the Working Draft IFRS [X] Liabilities. The GASB supports the removal of the 'outflow recognition criterion. But, in contrast to the Board, we advocate retaining the probability threshold as currently lined out in IAS 37.15 (which relates to the existence of an obligation) to determine whether there is a present obligation. We believe that we had not misread or misunderstood the existing IAS 37. The important features of the guidance mentioned in the IASB Staff Paper 'Recognising liabilities from lawsuits' should be included in the standard.

Please find our detailed comments on the questions raised in the ED in the Appendix to this letter. If you would like to discuss our comments further, please do not hesitate to contact me.

Yours sincerely,

Liesel Knorr
President

Appendix – Answers to the questions of the exposure draft

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

Measurement approach
We do not support the requirements proposed in paragraphs 36A–36F. We would prefer a measurement approach which reflects the way an entity intends to satisfy the obligation (management approach) rather than a measurement approach that considers alternatives that may be available but that the reporting entity has no intention to pursue. In our view measurement shall reflect reality. The application of the ED's concept 'the lowest amount' may be reasonable on a theoretical basis, but it would often result in a measurement which does not appropriately depict the entity's actual performance. In reality, an entity does not always choose the at first glance cheapest of all available settlement alternatives but may prefer to fulfil the obligation, because other factors are taken into account, e.g. costs of capacity usage, customer expectations etc. We believe that such management decisions need to be reflected in the financial statements of the entity to make them useful.

Entities normally fulfil rather than cancel or transfer their obligations. We therefore believe that the measurement requirements for liabilities should be based on a rebuttable presumption that the liability will be settled by fulfilment. Liabilities would thus be measured at their fulfilment value whenever the fulfilment presumption is not rebutted. Only if an entity has both, the intent and the possibility of cancelling or transfering the liability the entity would rebut the presumption and measure the liability based on the intended cancellation or transfer. Accordingly, only in such a situation, as well as the below-mentioned specific situation where an intangible asset may be internally generated, there is a need to determine the measurement amount of these alternatives.

If it is an entity's stated business model to fulfil its obligations to customers by its own performance no further analysis by the entity should be necessary to determine whether there is a 'cheaper' alternative.

However, there might be scenarios in which an entity has the possibility to choose between fulfilment, cancellation or transfer. If in a specific situation the entity consciously decides to fulfil the obligation although a transfer or cancellation would be obviously much cheaper, then the entity should analyse whether the difference or part of the difference between the fulfilment value and the lower price may qualify as an intangible asset. This may, for example, be the case if an entity believes that fulfilment of a customer-related obligation by the entity is necessary to improve and not just to maintain the relationship with the customer. In such a situation the entity actually does both, fulfil the obligation and acquire a customer relationship asset and the accounting should reflect this multiple element characteristic of the transaction. There may, however, be other scenarios in which the reason for fulfilling an obligation despite an available less costly alternative would not qualify for separate accounting.

In our opinion the second sentence in paragraph 36C of the ED ('If there is no evidence that an entity could cancel or transfer an obligation for a lower amount […]') is unclear, because we are not sure how far an entity's search should go in order to find any lower cancellation or transfer value. In other words: when is the entity entitled to stop its search? BC 11 does not give any further guidance regarding our question and therefore the Board should clarify this issue.

Expected value approach

The ED considers an expected value approach as an appropriate basis for measuring both liabilities for large populations and single obligations. The GASB supports the application of the expected value approach for large populations. But for single obligations we would advocate for the individual most likely outcome and therefore we do not agree with the measurement of single liabilities at their expected value. We doubt that a reliable measurement of single obligations based on the expected value approach will be possible whenever a small number of diverse probabilities are involved. An example to illustrate this is: An entity is defending a lawsuit. The entity believes that it has an obligation and that there is a 99% probability that it will have to pay CU 100. However, there is a 1% probability that the lawsuit results in an outflow of CU 1,000,000. If the entity measures this liability at its expected value (CU 10,099) there would be a 99% probability that CU 99 of the recorded liability would need to be reversed upon settlement. We doubt that such liability measurement provides decision-useful information. Additionally, such measurement would be overly sensitive to the unavoidable inaccuracy of measurement estimates. If, for example, the probability of the CU 1,000,000 outcome would be 2% rather than 1% the expected value would be CU 20,098 rather than CU 10,099. Further, we doubt that any reliable evidence showing the probability to be 2% instead of 1% may be obtained.

We believe that measuring single liabilities based on their most likely outcome avoids these weaknesses and thus is superior to the expected value approach even when considering that a most likely outcome approach for measuring single obligations would result in different measurement approaches for single obligations versus large population obligations.

Measuring single liabilities based on their most likely outcome has the additional advantage of reducing the following risk: U.S. law provides that in a court case all information available at the defendant is discoverable (i.e. available to the plaintiff) unless it is privileged under the Attorney-Client Privilege. However, the Attorney-Client Privilege cannot be claimed for information that has been provided to third parties (including the external auditor). Measuring single liabilities at their expected value requires, in contrast to the measurement under the current IAS 37, an evaluation of all possible outcomes. Providing the documentation of such evaluation to the external auditor makes the evaluation discoverable and thus makes the evaluation available to the plaintiff for use in court. The documentation may thus be used against the reporting entity which is not in the interest of the entity's investors. An example to illustrate this is: An entity is defending a lawsuit. The entity believes that it has an obligation. The possible outcomes are: 10% probability to pay 1,000,000, 80% probability to pay 10,000 and 10% probability to pay 1,000. Applying the proposed expected value approach an entity has to share all probabilities with the external auditor. At the same time all that information will also be available to the plaintiff. However, when according to the measurement rules of the current IAS 37 the most likely outcome is used, the entity gives information about this amount to the external auditor (and therefore to the plaintiff, but does not specify the probabilities of the other possible outcomes.

Question 2

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 the 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?

Obligation to be fulfilled by undertaking a service

It seems to us that the IASB would like to introduce a measurement approach that is similar to a fair value notion. This is especially obvious in the description of how to determine the fulfilment value in Appendix B of the ED, because the entity should use observable market prices although it intends to fulfil the obligation by itself.

The Board asserts in paragraph BC 21(a) of the ED that there is a market for most types of services. The GASB disagrees with this view. For example, repairing cars might be seen as a service for which a market exists. However, must Mercedes base the measurement of liabilities related to the repair of cars on what Porsche or any other car makers would charge for a technical service of a Mercedes car? Must Mercedes base the measurement on the cost level of an unauthorised backyard repair station? We say 'no', because Porsche is likely not able or willing to undertake a technical service for a Mercedes car, because of differences in Mercedes-related skills and technical equipment and the backyard repair station would obviously not represent a comparable source of evidence. We support the statement of the six dissenting IASB members in paragraph AV2(c) of the ED that there is no guidance about what constitutes a market and whether a referenced market should be a liquid market with observable market prices.

We prefer an approach that does not distinguish between service and cash obligations. This can be achieved measuring liabilities based on the expected costs of fulfilment. This would also work in cases in which an entity engages a subcontractor to fulfil a liability. Then the price the contractor would charge to the entity would be the entity's cost of fulfilment and thus basis for the measurement of the respective liability.

In paragraph B8 (b) of Appendix B the ED proposes that in situations where there is no market for the service an entity should estimate the amount it would charge another party at the future date to undertake the service including its costs as well as a profit margin. In line with the preferred fulfilment approach the GASB also disagrees with the proposed inclusion of a profit margin. The inclusion of such a profit margin would result in a higher expense at the time of recording the liability and a profit at the time of fulfilment. We do not believe that such accounting provides decision-useful information as we do not see what the profit at the time of fulfilment should represent. The following example illustrates our thinking: In period one an entity recognises a liability and respective expense of CU 1,100 that the entity expects to fulfil by providing a service and that therefore includes expected cost of CU 1,000 and a profit margin of CU 100. After one year the entity fulfils the liability by providing the service. As originally expected, the service results in cost of CU 1,000. The derecognition of the liability thus results in a gain of CU 100 in profit and loss because of the profit margin being released into profit. This approach, in our view, results in a distortion of the presented profit numbers and thus in an inadequate presentation.

Future events

Paragraph B12 and paragraph B13 of Appendix B both describe how future events should be taken into account. We understand the principle underlying the ED to be as follows: Future events should not be considered in the recognition of liabilities but they should be considered in their measurement. Assuming that our understanding is correct we would prefer this principle to be explicitly stated in the standard on liability measurement. We would welcome the fundamental discussion of this principle in the IASB's current conceptual framework project.

In our view the last sentence of paragraph B13 refers to the recognition of a liability. We do not understand why the IASB mentions this sentence in the measurement section. We encourage the IASB to clarify this paragraph.

Risk and uncertainties

In our view a risk adjustment should only be taken into account to the extent outlined in the existing IAS 37. Estimating the expected present value involves all possible outcomes. Possible risks should be reflected in these outcomes, so that no further risk adjustment is needed. In case of single obligations (which we advocate, as noted above, to be measured at their most likely outcome) it should be evaluated based on individual facts and circumstances whether a risk adjustment is appropriate. When a risk adjustment is taken into account, the future cash outflows should be adjusted for risk as appropriate under the current IAS 37 but should not be calculated in the way of a 'risk margin' as proposed by the ED and thus should not explicitly be presented in the financial statements as such.

Term 'all'

In Appendix B the IASB often uses the term 'all' such as 'all possible outcomes' (paragraph B4), 'all available information' (paragraph B5) and 'all available evidence' (paragraph B11). In our opinion the term 'all' goes too far as it requires an unrealistic assurance of completeness. We would interpret 'all' in the sense of 'necessary'. Therefore, the IASB should change the wording in order to make a better distinction.

Question 3
Paragraph B9 of Appendix B proposes a limited exception for onerous contracts arising from transactions within the scope of IAS 18 *Revenue* or 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 fulfil them on its behalf. Paragraphs BC23–BC27 of the Basis for Conclusions explain the reason for this exception.

Do you support the exception? If not, what would you propose instead and why?

We favour identical measurement principles for all onerous contracts. As outlined above, our preferred approach is based on costs expected in the future. Under this approach an exemption like the one outlined in paragraph B9 of Appendix B of the ED is not necessary.

Other issues

Scope
In our understanding warranties are in the scope of the existing IAS 37. In its Discussion Paper on revenue recognition, the IASB proposed that in the future warranties shall be within the scope of IAS 18. Therefore, we are not clear in which way warranties shall be treated in the near future. According to the IASB work plan the final standards on liabilities and revenue recognition will be published at different times. Accordingly, the effective dates of both standards will also be different. Hence, it is questionable how entities should account for warranties in the meantime.

Probability recognition criteria
The existing IAS 37 includes two probability thresholds. The first one in IAS 37.15 relates to the existence of an obligation and the second one in IAS 37.23 is concerned with the outflow of resources. We support retaining the first one. The current IAS 37 assumes that scenarios in which it is uncertain whether an obligation exist are limited to ‘rare cases’. By using the term ‘some situations’ rather than the IAS 37 term ‘rare cases’ the IASB’s working draft of the new standards obviously acknowledges that such scenarios are not rare. We even believe that they occur frequently. Take, for example, scenarios in which an entity is faced with a potential obligation shortly before the completion of its financial statements – as it may happen if the entity is

unexpectedly sued by a third party. The entity may not have enough time to evaluate the merits of the case. Additionally, in complex legal cases and customer claims different view may exist regarding the existence of a liability. For example, a pharmaceutical entity gets information that a class action lawsuit has been filed shortly before the completion of its financial statements. The lawsuit relates to side effects of a medicament which is produced by the entity. The number of plaintiffs is one hundred. In reality, to check the degree of undesired side effects in each case may take months or even years and therefore the entity has no chance to appropriately analyse the cases within the short time given.
Whenever it is unclear whether an obligation exists, the guidance in the current IAS 37 is helpful as it clarifies that a liability is to be recorded 'where it is more likely than not that a present obligation exists'. The IASB's working draft of the IAS 37 successor does not include similar language and it is unclear what impact this change in language should have. We believe that the IAS 37 guidance in this respect is very helpful and should be retained.

We believe that the second probability threshold in the current IAS 37 (i.e. probability of outflow of resources) is not needed if single obligations are measured based on the most likely outcome. In contrast, if single obligations are measured based on their estimated value as proposed by the ED, the probability threshold should be retained as otherwise the cost of identifying and evaluating the potentially manifold outcomes of an obligation would be excessive.

IASB Staff Paper 'Recognising liabilities arising from lawsuits'

We would welcome the inclusion of the main features of the content of the IASB Staff Paper on recognising liabilities arising from lawsuits in the standard, because this guidance would be helpful for preparers and users in the future. But we disagree with the conclusion made in paragraph 13 of the paper. In our view a liability should only be recognised if the entity has a present obligation. The continuation of a wrong accounting as described in paragraph 11 (b) of the paper does not justify the recognition of a liability when applying the new IFRS.

Onerous Contracts

Paragraph C9 (a) of the IASB's working draft of the IAS 37 successor provides guidance for scenarios in which a contract becomes onerous because the entity ceases to use the rights conveyed by the contract but continues to incur obligations to make payments under the contract. For such scenarios the working draft provides that 'The entity shall not recognise a liability until it ceases to use the rights conveyed by the contract'. We believe that this guidance may not result in an accounting that follows the principles that we believe underlie the working draft. Take, for example, an entity that decides to cease the use of a leased building. A cancellation of the lease contract is not possible but the entity can sublease the building. The entity enters into a sublease contract with a third party with lease rates below the lease rates that the entity pays to the building's landlord. The entity vacates the building shortly before the sublease term begins which is some time after the sublease contract has been entered into. In such a scenario we believe that the onerous contract liability has to be recorded upon entering into the sublease arrangement rather than upon vacating the building. We fear that the language in the working draft may be misunderstood to not allow recognition of a liability before vacating the building.

Wording in paragraph 5 of the Working Draft of the standard on liabilities

In our view the term 'expenses' is not suitable to describe negative adjustments of revenue. We would suggest replacing the term with the phrase 'debit in profit or loss'.