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DSR-Sitzung:	**143. / 12.04.2010 / 10:00 – 11:30 Uhr**
TOP:	**02 – ED amend IAS 37**
Thema:	**Vorbereitung der Stellungnahme (2. Entwurf der Stellungnahme)**
Papier:	**143_02a_ED amend IAS 37_2. Entwurf_SN**

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Sir David Tweedie
Chairman of the
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30 Cannon Street

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Berlin, 12. 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.

In our view a final assessment of the proposed measurement approach is only possible if the scope is sufficiently clear. At the moment warranties are in the scope of the existing IAS 37. In its Discussion Paper on revenue recognition, the IASB proposed that warranties ~~and guarantees~~ shall be within the scope of IAS 18 in the future. Therefore, we are not sure in which way warranties shall be treated in the near future. A look at the IASB work plan shows that the final standards on liabilities and revenue recognition will be published at different times. Accordingly, the effective dates of both standards shall also be different. Hence, it is questionable how entities should account for warranties ~~and guarantees~~ in the meantime. ~~If warranties and guarantees are to be within the scope of liabilities in IFRS, the GASB would assess the inclusion of a risk adjustment differently (see our detailed comment in the Appendix).~~

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 satisfaction alternatives that are available but that the reporting entity has no intention to pursue. In our view measurement shall reflect the reality. The application of the ED's concept 'the lowest amount' may be reasonable on a theoretical bases, but it would oftentimes results in an unrealistic measurement. In reality, an entity does not always choose the cheapest of all available settlement alternatives but may prefer to fulfil the obligation, although this way of liability satisfaction is more expensive than others. We believe that such management decisions need to be reflected in the financial statements of the entity to make them useful. ~~The principle mentioned above should be incorporated in the measurement objective.~~

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 wherever the fulfilment presumption is not rebutted. Only if an entity has both, the intent and the possibility of cancellation or transfer the liability the entity would rebut the presumption and measure the liability based on the intended cancellation or transfer. We believe that such a measurement approach is superior to the approach proposed by the IASB with regard to the efforts needed to identify different measurement alternatives and regarding the reflection of reality in the liability measurement.

In contrast to the Board, we have a different understanding of how a fulfilment value 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. This would especially be obvious in the description of how fulfilment value is to be determined in Appendix B of the ED, because the entity should use observable market prices even if it intends to fulfil the obligation by itself.

Our approach is based on expected costs of fulfilment, so in contrast to the Board, we would support a cost notion and not a fair value notion. A profit margin would not be included in our approach. ~~In principle, we would not take a risk adjustment into account.~~ A risk adjustment should be taken into account only as required by the existing IAS 37.

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

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 the retaining of the first one and we would like to point out that we had not misread or misunderstood the existing IAS 37.

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?

We do not support the requirements proposed in paragraphs 36A–36F. We would ~~support~~prefer a measurement approach which reflects the way an entity intends to satisfy the obligation (management approach) rather than a measurement approach that considers satisfaction alternatives that are available but that the reporting entity has no intention to pursue. In our view measurement shall reflect the reality. The application of the ED's concept 'the lowest amount' may be reasonable on a theoretical basis, but it would oftentimes results in an unrealistic measurement. In reality, an entity does not always choose the cheapest of all available settlement alternatives but may prefer to fulfil the obligation, although this way of liability satisfaction is more expensive than others. We believe that such management decisions need to be reflected in the financial statements of the entity to make them useful.~~ The principle mentioned above should be incorporated in the measurement objective~~.

There are scenarios in which the reason why an entity chooses to fulfil an obligation rather than to cancel or transfer it at a 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 improves the relationship with the customer compared to an available cancellation or transfer. In such a scenario 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 available less costly settlement alternatives does not qualify for separate accounting.

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 wherever the fulfilment presumption is not rebutted. Only if an entity has both, the intent and the possibility of cancellation or transfer the liability the entity would rebut the presumption and measure the liability based on the intended cancellation or transfer. We believe that such a measurement approach is superior to the approach proposed by the IASB with regard to the efforts needed to identify different measurement alternatives and regarding the reflection of reality in the liability measurement. ~~However, in our opinion the wording in paragraph 36C of the ED is unclear. We are not sure who has the burden of proof.~~

~~We reviewed paragraphs 36A-36F in connection with the determination of the fulfilment value in Appendix B of the ED. We are of the opinion that especially the explanations in paragraph B8 of Appendix B would result in the IASB implementing a measurement approach that is similar to a fair value notion (see Question 2 for detailed comments).~~

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.

We also 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 low probabilities are involved. An example to illustrates this is: An entity 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 100,000. However, there is a 1% probability that the lawsuit results in an outflow of CU 1 billion. If the entity recorded this liability at its expected value (CU 10.099 million) there would be a 99% probability that CU 9.999 million 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 sensible to the unavoidable inaccuracy of measurement estimates. If, for example, the probability of the CU 1 billion outcome would be 2% rather than 1% the expected value would be CU 20.098 million rather than CU 10.099 million.

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.

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, must Mercedes base the measurement of liabilities related to the repair of cars on what Porsche or other car makers would charge for a technical service of a Mercedes car? We say 'no', because Porsche is likely not able to undertake a technical service such as Mercedes performs, because of differences in Mercedes-related skills an technical equipment. 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 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.

The GASB 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 five years 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. Additionally, we would welcome a fundamental discussion of this principle in the IASB's current conceptual framework project.

In this context the last sentence of paragraph B13 with the example 'change in legislation' confuses us. The term 'change' implies to us that it is a question of measurement. We do not understand why the IASB mentions 'create new obligations' in this sentence. We encourage the IASB to clarify this paragraph.

Risk adjustment

In our view a risk adjustment should be taken into account only as required by 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 prefer, 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.

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 expected costs. Under this approach an exemption like the one outlined in paragraph B9 of Appendix B of the ED is not necessary.

Other issues

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 sued by a third party. The entity may simply not have enough time to evaluate the merits of the case. Additionally, in complex legal cases and customer claims it may different view may exist regarding the existence of a liability.

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 the probability threshold should be retained as otherwise the cost of identifying and evaluating the potential outcomes of an obligation would be excessive.

Hinweis

Herr Hütten schlägt vor, den folgenden Punkt in die Stellungnahmen aufzunehmen.

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 is rule based and 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.