

# Rådet för finansiell rapportering

The Swedish Financial Reporting Board

RFR-rs 2010:03

International Accounting Standards Board  
30 Cannon Street  
London EC4M 6 XH  
United Kingdom

Dear Sirs,

## **Re: ED/2010/1 Measurement of Liabilities in IAS 37 – Proposed amendments to IAS 37**

The Swedish Financial Reporting Board is responding to your invitation to comment on the International Accounting Standard Board's partial reexposure of IAS 37.

We regret that the whole IAS 37 is not reexposed. It is not appropriate to comment on single parts of a standard when the proposals in the entire standard are linked together. We believe that there is a fundamental need to consider recognition and measurement at the same time. We have therefore also reviewed the recently issued IFRS working draft.

In summary we consider that the proposed changes in the measurement model, combined with the change in the recognition model, leads to a reduction in decision-useful financial reporting. The consequence of this is that IAS 37, which in our experience works quite well, should not be withdrawn. Instead the IASB should update the standard without changing its basic features.

Our main concerns regarding the exposure draft are summarised below.

### *The removal of the "more likely than not" criteria*

This is a dramatic change, removing the classification into liabilities and contingent liabilities. The objective of the IASB that the measurement of contingent liabilities in IAS 37 should converge with that in IFRS 3 is in our view misdirected. IFRS 3 requires assets and liabilities to be measured at fair value; IAS 37 does not. In an acquisition it can be expected that the purchase price is affected by the acquirer's assessment of issues associated with the acquiree. Therefore, to record contingent liabilities on the date of an acquisition improves the financial reporting, since otherwise goodwill or negative goodwill resulting from the acquisition may be distorted. To record contingent liabilities as liabilities under IAS 37 results in liabilities that in many cases will never be settled, something which reduces the decision-usefulness of the financial reporting and could have long-lasting negative implications on the valuation of the company. Our concerns in this area are further amplified when we review the recently issued IFRS

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working draft, which we find unclear as to when a liability exists. We also see significant practical problems in determining the existence, based on uncertainty, of a possible liability, which will only be subject to disclosure.

*Including a profit margin in the measurement of a liability for a service commitment in case when the service will be completed by the entity itself*

Such an inclusion results in an irrelevant estimate that decreases the usefulness of the financial reporting. Also, when such a liability, in connection with a decommissioning obligation, results in an asset in accordance with IAS 16 such an asset will include an unearned profit margin instead of being recognised at cost as this standard requires. In addition, we consider that the IASB overestimates the occurrence of service markets for various kinds of services.

*Including a risk adjustment in the measurement of a liability*

It is unclear, due to lack of guidance, what this adjustment represents and as a consequence it could result in the recording of an additional profit margin, which would further reduce the usefulness of the financial reporting. Obviously risks are always reflected when the resources required to fulfil an obligation are estimated. To specifically require that a risk adjustment should be included in the liability is just confusing.

*Basing the measurement of a liability on the expected value instead of on the most likely outcome*

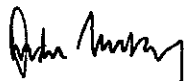
We believe for liabilities with no historical experience the likelihood for different outcomes will be difficult, if not impossible, to determine. Also the inclusion of low likelihood scenarios representing high amounts may distort the liability calculation in a significant way. This cook-book approach will consume significant management resources without any improvement in financial reporting and should therefore not be introduced.

If the IASB should decide to not follow our recommendation but instead pursue its work in line with the working draft the attached exhibit sets out some aspects that in our view must be considered.

If you have any questions concerning our comments please address our Executive member Carl-Eric Bohlin by e-mail to: [carl-eric.bohlin@radetforfinansiellrapportering.se](mailto:carl-eric.bohlin@radetforfinansiellrapportering.se)

Stockholm, 14 April, 2010

Yours sincerely



Anders Ullberg  
Chairman

## Remarks related to the IFRS working draft

### *Structure of standard*

We fail to see the logic in leaving some parts of the standard unchanged because they relate to other standards that are being developed, while separately implementing a detailed remark that affects revenue recognition.

We would like to highlight that not only the onerous contracts have direct links into the revenue recognition standard; one other example of this is warranty obligations as pointed out in the Alternative views.

### *The removal of "more likely than not" criteria*

The removal of the "more likely than not criteria" is dramatically changing the number of obligations that need to be recognised. This may be especially irrelevant for remote liabilities that previously were not even part of the contingent liabilities. The removal of the "more likely than not criteria" transforms contingent liabilities into liabilities, which also has the implication of increasing the importance of an accurate and precise measurement of those liabilities due to the focus on the income statement numbers, compared to the notes. Implementing such a change without very clear principles will unavoidably result in a wide practice that in turn will distort the quality of the financial reporting. The resulting reduction in quality will be complemented with increased administrative costs due to the increase in complexity in the application of IAS 37.

We, therefore, believe that the implementation of any changes in IAS 37 should be aligned with the implementation of changes in the Revenue recognition standard as well as in IFRS 4.

### *Measurement model*

As the IASB is fully aware of, some liabilities qualify for IAS 39, IFRS 4 and IAS 37 at the same time (e.g. some guarantee contracts). Those entities that have chosen to use IAS 37 for these liabilities will suffer a measurement mismatch due to the inconsistent treatment of liabilities and their future income streams. The compensation that the entity receives is normally amortised during the life of the guarantee contract while the proposed IAS 37 would result in the recognition of a probability-weighted day-one loss. We believe that the income stream and the possible future liability should be measured using the same measurement basis.

Reading paragraphs 36A, B, C, D and E without reference to Appendix B creates an expectation that that the proposed changes in IAS 37 are reasonable and in line with the way management may consider valuing liabilities. However, Appendix B *excludes the most probable* outcome methodology for estimating liabilities and instead introduces a requirement to identify all possible outcomes. We believe that this is an unjustified requirement. Instead Appendix B should focus on describing circumstances

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Exhibit

where it would be enough to use the most probable outcome (the implicit expected average value in a normal distribution) and when, as a second alternative, it might be necessary to use the methodology of identifying all possible outcomes.

Furthermore, we believe that paragraphs B4 and B5 are inconsistent. Paragraph B4 states that "it is not always necessary to consider distributions of literally all possible outcomes" while paragraph B5 (a) states "The estimates of the outflows of resources required to fulfil the obligation shall "incorporate, in and unbiased way, all available information.....".

We also believe that paragraph B8 is inconsistent with paragraph 36B since the latter states that a liability should be measured at "the lowest of" the different alternatives. We believe that it is reasonable to expect that an entity's *own service* organisation is superior in delivering services attached to its own products compared to external contractors. Therefore, we do not agree with that the usage of external contractors always should result in a measurement that is "the lowest" of different alternatives, despite the fact that an entity's own organisation could carry out the work at a lower cost.

Furthermore, the IASB overestimates the occurrence of relevant service markets of this kind. We believe that there is no transparent market for most services. In paragraph BC22 the IASB expresses their belief by referring to paragraph B8 (b), which justifies the usage of external prices by stating that what the entity would charge another entity to fulfil the service is only the second best alternative. We believe that this is irrelevant for two different reasons:

1. Having a service organisation that is able to service several different entities products would require a more educated service organisation than one that just focuses on the own products. It would probably be more costly.
2. Including a profit margin does not reflect future outgoing cash-flows. We therefore do not share the view expressed by the IASB in paragraph BC21 (e). Using that view would lead to the questioning of several other principles presently being applied, e.g. the depreciation of construction costs (using historical costs instead of replacement cost and so on). We believe that if an entity actually intended to outsource the service obligations, the initial pricing would be different than if the entity expects to fulfil the service liability itself.

#### *Effects on other standards*

The expected recognition requirements and the proposed measurement requirements could, if implemented, affect subsequent work with respect to other IFRSs, something which should be considered.