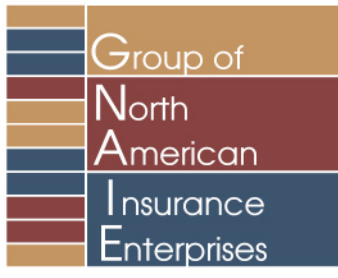

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**November 30, 2005**

Sir David Tweedie, Chairman
International Accounting Standards Board
30 Cannon Street, London EC4M 6XH, United Kingdom
copy to: FASB Chairman Robert Herz

**Exposure Draft of Proposed Amendments to *IAS 37 Provisions, Contingent Liabilities and Contingent Assets* (IAS 37) and *IAS 19 Employee Benefits***

Dear Sir David:

The chief financial officers of twelve leading insurance companies including life insurers, property and casualty insurers, and reinsurers formed the Group of North American Insurance Enterprises (GNAIE) in 2003. GNAIE members include the largest global providers of insurance and multi-national corporations. All are major participants in the US markets. The goal of GNAIE is to influence international accounting standards to ensure that they result in high quality accounting standards for insurance companies and, to that end, to increase communication between insurers doing business in North America, the International Accounting Standards Board (IASB) and the United States Financial Accounting Standards Board (FASB). GNAIE works to meet its goals through modeling of proposed accounting standards, analysis, comment, and coordination with various end users of financial reports.

We thank you for the opportunity to comment on the recently issued Exposure Draft of Proposed Amendments to *IAS 37 Provisions, Contingent Liabilities and Contingent Assets* (IAS 37) and *IAS 19 Employee Benefits*. We appreciate the extension of time given to consider the comments and discussions at the roundtable. We will provide general comments as well as address the questions in the exposure draft.

We support convergence between International Accounting Standards and U.S. GAAP and are encouraged by the stated goals of the exposure draft; however, we have serious concerns:

The document diverges with one of the cornerstones of U.S. GAAP, FASB Statement No. 5, *Accounting for Contingencies* (FAS 5), and fails to address why the accounting should diverge from FAS 5.

We do not believe that IAS 37 is improved by recording a liability for an obligation that is not probable or recording an impairment of an asset that is not probable.

The exposure draft creates new liability recognition and measurement criteria that may have far reaching implications when these criteria have not been fully vetted

by either the FASB or IASB within their framework projects.

The potential that entities will record liabilities for which the likelihood of cash outflow is remote is a major change in the accounting literature that should be deliberated with great care.

We do not believe the guidance would improve financial reporting since recording many of the liabilities that are subject to this guidance would involve highly subjective and uncertain estimates.

We do not believe that discounting probability weighted cash flows for a single liability is appropriate since it is not statistically reliable. It is only appropriate for a homogenous group of liabilities (law of large numbers).

We believe that adequate disclosure of non-probable risks and uncertainties is more understandable for, and more appropriately used by, the end users of the financial statements. We believe that recording non-probable liabilities implies to users an artificial level of precision that does not exist and users will overly rely on such recorded amounts.

We strongly disagree with the assertion that "except in extremely rare cases, an entity will be able to determine a reliable measure of a liability". For example, most lawsuits in the United States (U.S.) cannot be reliably measured until the case is fairly advanced due to the structure of the legal system in the U.S. where plaintiffs have the right to a jury trial, punitive damages can be and are assessed, there is no cost shifting of trial expenses to unsuccessful plaintiffs and awards are not prescribed.

Although we believe fair value for some assets and liabilities can be reliably measured, such as those with observable markets, we do not believe that fair value measurement is appropriate for non-financial liabilities since there is no established market for most of these liabilities and the use of discounted cash flows will result in highly unreliable and non-comparable financial statements. If the capital markets, which are adept at pricing assets and liabilities, determined that the cost of lawsuits could be priced with a reasonable level of reliability, there would already be an active market.

A major concern for U.S. registrants and their liability insurers is the potential change in the litigation environment as a result of the proposed amendments. Companies would be forced to record and disclose estimates prior to any substantial negotiation with the plaintiff. We believe this would cause an increase in ultimate settlement amounts as a result of providing the plaintiff with a stronger negotiating position as this information will be available to the plaintiff in the discovery process. Once the plaintiff gains access to the defendant's calculation of the recorded liability, they will be able to determine the gross amount which likely will establish the floor for future negotiations.

For example, suppose that a company is served with a subpoena before the end of a quarter and it has enough information to record a liability, which is a relatively low hurdle in the exposure draft. The company would have to record a liability under this guidance even though the company believes it is probable that it will prevail and even though the measurement of the liability is very uncertain. In some cases, the amount recorded in the financial statements could be more than what the plaintiff is seeking; however, the recorded amount would be used by the plaintiff as a starting point in any settlement negotiations.

More importantly, the very nature of recording a liability will lend credibility to a lawsuit where the plaintiff otherwise had a low chance of prevailing, especially when the standard suggests that the liability is "measured reliably". This information could be used in a court of law as

evidence that the company acknowledges liability. We believe this guidance would complicate lawsuits for defendants and would influence companies to understate the probabilities of various outcomes so as to minimize liabilities recorded because they could be used as evidence against them. Also, we believe paragraph 71 (disclosure exception) would not be helpful to defendants since it conflicts with applicable SEC disclosure rules.

Another concern for U.S. registrants is the potential increase in shareholder litigation due to shareholders relying on financial statement information that they believed was precise and certain, when in fact significant uncertainty was included in the statements. Recording and disclosing liabilities based on cash flow modeling and significant assumptions implies a high level of precision where none exists. There is no market for the sale or purchase of lawsuits nor of indemnification agreements relating to known lawsuits and without such a market it is extremely difficult to determine if the assumptions used in calculating the liability are appropriate.

This potential standard would put U.S. registrants and all companies conducting business in the U.S. in a precarious position. If a company records a liability that is too high it could lead to a settlement or judgment in excess of the true value of the lawsuit. Conversely if a company records a liability that is too low and subsequently pays an amount that is materially greater it may be the subject of a shareholder suit. Considering this environment further makes measurements under these proposed amendments extremely problematic.

**Question 1 – Scope of IAS 37 and terminology**

The Exposure Draft proposes to clarify that IAS 37, except in specified cases, should be applied in accounting for all non-financial liabilities that are not within the scope of other Standards (see paragraph 2). To emphasise this point, the
Exposure Draft does not use ‘provision’ as a defined term to describe liabilities within its scope. Instead, it uses the term ‘non-financial liability’ (see paragraph 10). However, the Exposure Draft explains that an entity may describe some classes of non-financial liabilities as provisions in their financial statements (see paragraph 9).

| 1 (a)Do you agree that IAS 37 should be applied in accounting for all non-financial liabilities that are not within the scope of other Standards? If not, for which type of liabilities do you regard its requirements as inappropriate and why? |
|---|

**In principle, we believe it is appropriate to have a liability category that captures all liabilities not subject to other guidance. However, we would be concerned with the potential unintended consequences of applying the recognition and measurement requirements of this proposed guidance to liabilities where it might not be appropriate. Although we have not had the opportunity to contemplate all impacted liabilities, we believe a full inventory of the types of liabilities that would be subject to this guidance should be developed and the inventory should be evaluated to determine if this guidance would be appropriate.**

| 1 (b) Do you agree with not using ‘provision’ as a defined term? If not, why not? |
|---|

**We agree with the elimination of provision as a defined term as long as it is consistently eliminated throughout the standards.**

**Question 2 – Contingent liabilities**
The Exposure Draft proposes to eliminate the term 'contingent liability'. The Basis for Conclusions on the proposals in the Exposure Draft explains that liabilities arise only from unconditional (or non-contingent) obligations
(see paragraph BC11). Hence, it highlights that something that is a liability (an unconditional obligation) cannot be contingent or conditional, and that an obligation that is contingent or conditional on the occurrence or non-occurrence of a future event does not by itself give rise to a liability (see paragraph BC30).

The Basis for Conclusions also explains that many items previously described as contingent liabilities satisfy the definition of a liability in the *Framework*. This is because the contingency does not relate to whether an unconditional obligation exists. Rather it relates to one or more uncertain future events that affect the amount that will be required to settle the unconditional obligation (see paragraph BC23). The Basis for Conclusions highlights that many items previously described as contingent liabilities can be analysed into two obligations: an unconditional obligation and a conditional obligation. The unconditional obligation establishes the liability and the conditional obligation affects the amount that will be required to settle the liability (see paragraph BC24).

The Exposure Draft proposes that when the amount that will be required to settle a liability (unconditional obligation) is contingent (or conditional) on the occurrence or non-occurrence of one or more uncertain future events, the liability is recognised independently of the probability that the uncertain future event(s) will occur (or fail to occur). Uncertainty about the future event(s) is reflected in the measurement of the liability recognised (see paragraph 23).

| 2 (a) Do you agree with eliminating the term 'contingent liability'? If not, why not? |
|---|

**No, we do not understand how this change will improve financial reporting. We believe 'contingent liability' is a well understood term that adequately describes uncertain obligations. Furthermore, we find the term 'non-financial liability' confusing where 'contingent liability' is not. Non-financial liability in plain language would be understood as one that would not settle through monetary payment. Although a careful reading will show that the intended meaning is a monetary liability other than pursuant to a financial instrument within the scope of IAS 39 and other than pursuant to another IAS, this is not intuitive. We recommend that the plain language term 'contingent liability' be preserved.**

| 2 (b) Do you agree that when the amount that will be required to settle a liability (unconditional obligation) is contingent on the occurrence or non-occurrence of one or more uncertain future events, the liability should be recognised independently of the probability that the uncertain future event(s) will occur (or fail to occur)? If not, why not? |
|---|

**We understand the theoretical argument; however, we question if bifurcating the contingency into two components to determine if either component meets the definition of liability is appropriate since, in most cases, the unconditional obligation and the conditional obligation are inseparable. The exposure draft demonstrates this in using the projected cash outflows of the conditional obligation to value the unconditional obligation (the unconditional liability is not independent of the probability of the uncertain future events). If the obligations were truly separable, one**

**would think that they would each have a value that is determined by its own characteristics.**

**Furthermore, we find the idea that an unconditional liability is based on the value of a conditional liability to be overly complex language when it appears that the intention is simply to have contingent liabilities be based on probability-weighted present values or "fair values".**

**Additionally, we don't believe that it is appropriate to recognize a liability for contingencies that are not probable. This guidance will require a liability for every lawsuit filed against a company since there is most likely some chance, no matter how remote the possibility, that a company may lose. This will have practical workflow issues as well, as companies that receive a significant number of lawsuits that are currently evaluated as not probable will now have to assign probabilities and value the contingencies as liabilities. Every reporting period, a review of each subjective factor used in valuing the lawsuit would have to be performed. Further, companies would have to look at all claims since the aggregate value of immaterial lawsuits may be material. The reporting of these liabilities would imply a level of precision that does not exist.**

**Question 3 – Contingent assets**

The Exposure Draft proposes to eliminate the term 'contingent asset'. As with contingent liabilities, the Basis for Conclusions explains that assets arise only from unconditional (or non-contingent) rights (see paragraph BC11). Hence, an asset (an unconditional right) cannot be contingent or conditional, and a right that is contingent or conditional on the occurrence or non-occurrence of a future event does not by itself give rise to an asset (see paragraph BC17).

The Basis for Conclusions also explains that many items previously described as contingent assets satisfy the definition of an asset in the *Framework*. This is because the contingency does not relate to whether an unconditional right exists.
Rather, it relates to one or more uncertain future events that affect the amount of the future economic benefits embodied in the asset (see paragraph BC17). The Exposure Draft proposes that items previously described as contingent assets that satisfy the definition of an asset should be within the scope of IAS 38 *Intangible Assets* rather than IAS 37 (except for rights to reimbursement, which remain within the scope of IAS 37). This is because such items are non-monetary assets without physical substance and, subject to meeting the identifiability criterion in IAS 38, are intangible assets (see paragraph A22 in the Appendix). The Exposure Draft does not propose any amendments to the recognition requirements of IAS 38.

| 3 (a) Do you agree with eliminating the term 'contingent asset'? If not, why not? |
|---|

**No, we do not understand how this change will improve financial reporting. We believe that naming contingent assets "intangible assets" is extremely confusing. We understand the theoretical thinking that a contingent asset can be thought of as a conditional asset and an unconditional asset; however the practical application appears to defy logic. The logic employed appears to be the following: the unconditional portion of a contingent asset is a non-monetary asset since there is not a fixed or determinable amount of money to be received; and since the unconditional**

**asset is an identifiable non-monetary asset without physical substance it meets the definition of intangible asset. It is difficult to understand how a portion of a contingent asset would qualify as an intangible asset when then the contingency will only be settled monetarily or will be written off when it is determined to have no value.**

| 3 (b) Do you agree that items previously described as contingent assets that satisfy the definition of an asset should be within the scope of IAS 38? If not, why not? |
|---|

**No, we believe that contingent assets have significantly different characteristics than intangible assets. Intangible assets are other than monetary assets, controlled by the entity, provide a definite benefit and have either a definite or indefinite useful life. Contingent assets encompass monetary assets that are not controlled by the entity and are only potential assets of a company. We do not believe there is a need to revise the current guidance.**

**Question 4 – Constructive obligations**

The Exposure Draft proposes amending the definition of a constructive obligation to emphasise that an entity has a constructive obligation only if its actions result in other parties having a valid expectation on which they can reasonably rely that the entity will perform (see paragraph 10). The Exposure Draft also provides additional guidance for determining whether an entity has incurred a constructive obligation (see paragraph 15).

| 4 (a) Do you agree with the proposed amendment to the definition of a constructive obligation? If not, why not? How would you define one and why? |
|---|

**We agree with the intent of the guidance as discussed in the Basis of Conclusions; however, we are unsure in practice how "a valid expectation on which they can reasonably rely on the entity to perform" will be implemented and audited.**

| 4 (b) Is the additional guidance for determining whether an entity has incurred a constructive obligation appropriate and helpful? If not, why not? Is it sufficient? If not, what other guidance should be provided? |
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**The additional guidance is helpful.**

**Question 5 – Probability recognition criterion**

The Exposure Draft proposes omitting the probability recognition criterion (currently in paragraph 14(b)) from the Standard because, in all cases, an unconditional obligation satisfies the criterion. Therefore, items that satisfy the definition of a liability are recognised unless they cannot be measured reliably. The Basis for Conclusions emphasises that the probability recognition criterion is used in the *Framework* to determine whether it is probable that settlement of an item that has previously been determined to be a liability will require an outflow of economic benefits from the entity. In other words, the *Framework* requires an entity to determine whether a liability exists before considering whether that liability should be recognised. The Basis notes that in many cases, although there may be uncertainty about the amount and timing of the resources that will be required to settle a liability, there is little or no uncertainty that settlement will require *some* outflow of resources. An example is an entity that has an obligation to decommission plant or to restore previously contaminated land. The Basis also outlines the Board's conclusion that in cases previously described as

contingent liabilities in which the entity has an unconditional obligation and a conditional obligation, the probability recognition criterion should be applied to the unconditional obligation (ie the liability) rather than the conditional obligation. So, for example, in the case of a product warranty, the question is not whether it is probable that the entity will be required to repair or replace the product. Rather, the question is whether the entity's *unconditional* obligation to provide warranty coverage for the duration of the warranty (ie to stand ready to honour warranty claims) will probably result in an outflow of economic benefits (see paragraphs BC37-BC41). The Basis for Conclusions highlights that the *Framework* articulates the probability recognition criterion in terms of an outflow of economic benefits, not just direct cash flows. This includes the provision of services. An entity's unconditional obligation to stand ready to honour a conditional obligation if an uncertain future event occurs (or fails to occur) is a type of service obligation. Therefore, any liability that incorporates an unconditional obligation satisfies the probability recognition criterion. For example, the issuer of a product warranty has a certain (not just probable) outflow of economic benefits because it is providing a service for the duration of the contract, ie it is standing ready to honour warranty claims (see paragraphs BC42-BC47).

| 5 Do you agree with the analysis of the probability recognition criterion and, therefore, with the reasons for omitting it from the Standard? If not, how would you apply the probability recognition criterion to examples such as product warranties, written options and other unconditional obligations that incorporate conditional obligations? |
|---|

**We do not agree that probability should be removed from the recognition criteria. We believe the current standard has been proven practicable to the entities applying the guidance and understandable to the end users of the financial statements. We do not believe that it is representationally faithful to record liabilities for which the entity believes the likelihood of a cash outflow is remote as these measures are neither reliable nor releveant to financial statement users.**

**Question 6 – Measurement**

The Exposure Draft proposes that an entity should measure a non-financial liability at the amount that it would rationally pay to settle the present obligation or to transfer it to a third party on the balance sheet date (see paragraph 29). The Exposure Draft explains that an expected cash flow approach is an appropriate basis for measuring a non-financial liability for both a class of similar obligations and a single obligation. It highlights that measuring a single obligation at the most likely outcome would not necessarily be consistent with the Standard's measurement objective (see paragraph 31).

| 6 Do you agree with the proposed amendments to the measurement requirements? If not, why not? What measurement would you propose and why? |
|---|

**No, we do not agree with the measurement requirements, and particularly in measuring a single obligation. Using probability weighted cash flow scenario analysis in measuring a single potential liability in itself is not statistically reliable due to the subjectivity of the assumptions (selection of probabilities, appropriate discount rate, risk adjustment and timing of cash outflows). Two entities subject to the same potential liability could calculate significantly different values due to the use of slightly different, yet both reasonable, assumptions. We do not feel that this proposed measurement criteria is any more reliable than the entity's best estimate.**

**Additionally, as previously stated, this measurement approach raises practical concerns if companies were required to implement this proposed guidance. Companies with a substantial volume of low-value lawsuits would have to spend a significant amount of time determining what the potential cash outflows could be, applying supportable probabilities to the estimated cash outflows and discounting those cash flows. We believe the costs of applying the guidance would far outweigh the benefits to the financial statement readers.**

**We also do not believe that adding an adjustment for risks and uncertainties strengthens the argument for fair value measurement. In fact it highlights the very problem with this proposed guidance: that many of the non-financial liabilities recorded under this proposed guidance would be extremely uncertain as to timing, amount and whether or not they will ever come to fruition. Additionally, without an adequate proxy for risk margins and additional guidance on the adjustment for risks specific to the liability, preparers may employ significantly divergent assumptions leading to non-comparability of financial statements. We believe that adequate disclosure far outweighs recording uncertain liabilities and is significantly more understandable for, and more appropriately used by, the financial statement readers.**

**Question 7 – Reimbursements**

The Exposure Draft proposes that when an entity has a right to reimbursement for some or all of the economic benefits that will be required to settle a non-financial liability, it recognises the reimbursement right as an asset if the reimbursement right can be measured reliably (see paragraph 46).

7 Do you agree with the proposed amendment to the recognition requirements for reimbursements? If not, why not? What recognition requirements would you propose and why?

**We agree that reimbursements should be recognized and measured consistently with the associated contingent liabilities. However, where we have indicated that contingent liabilities are not reliably measurable we would similarly say potential recoveries are not either.**

**Question 8 – Onerous contracts**

The Exposure Draft proposes that if a contract will become onerous as a result of an entity's own action, the liability should not be recognised until the entity takes that action. Hence, in the case of a property held under an operating lease that becomes onerous as a result of the entity's actions (for example, as a result of a restructuring) the liability is recognised when the entity ceases to use the property (see paragraphs 55 and 57). In addition, the Exposure Draft proposes that, if the onerous contract is an operating lease, the unavoidable cost of the contract is the
remaining lease commitment reduced by the estimated sublease rentals that the entity could reasonably obtain, regardless of whether the entity intends to enter into a sublease (see paragraph 58).

8 (a) Do you agree with the proposed amendment that a liability for a contract that becomes onerous as a result of the entity's own actions should be recognised only when the entity has taken that action? If not, when should it be recognised and why?

**We agree that if a company takes an action that causes a contract to become onerous, a liability should be recorded.**

| 8 (b) Do you agree with the additional guidance for clarifying the measurement of a liability for an onerous operating lease? If not, why not? How would you measure the liability? |
|---|

**Yes, we agree.**

| 8 (c) If you do not agree, would you be prepared to accept the amendments to achieve convergence? |
|---|

**Not applicable.**

**Question 9 – Restructuring provisions**
The Exposure Draft proposes that non-financial liabilities for costs associated with a restructuring should be recognised on the same basis as if they arose independently of a restructuring, namely when the entity has a liability for those
costs (see paragraphs 61 and 62). The Exposure Draft proposes guidance (or provides cross-references to other
Standards) for applying this principle to two types of costs that are often associated with a restructuring: termination benefits and contract termination costs (see paragraphs 63 and 64).

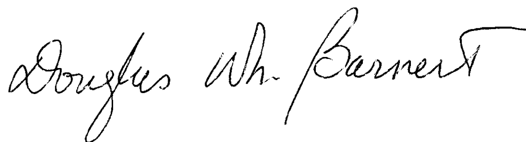
| 9 (a) Do you agree that a liability for each cost associated with a restructuring should be recognised when the entity has a liability for that cost, in contrast to the current approach of recognising at a specified point a single liability for all of the costs associated with the restructuring? If not, why not? |
|---|

**Yes, we agree.**

| 9 (b) Is the guidance for applying the Standard's principles to costs associated with a restructuring appropriate? If not, why not? Is it sufficient? If not, what other guidance should be added? |
|---|

**Yes, the guidance appears appropriate and is consistent with FASB Statement No. 146,** *Accounting for Costs Associated with Exit or Disposal Activities.*

Respectfully submitted,



Douglas Wm. Barnert
Executive Director

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