



**Date:** May 19, 2010

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

**Copies to:** FASB Board Members

**From:** Group of North American Insurance Enterprises (“GNAIE”)

**Subject:** Exposure Draft ED/2010/1 – *Measurement of Liabilities in IAS 37*

---

GNAIE appreciates the opportunity to comment on the re-exposure of proposed amendments to IAS 37 (“ED”). We expanded our comments beyond the limited exposure of the ED after thorough review of the 19 February 2010 Working Draft (“WD”) of International Financial Reporting Standard [X] – **Liabilities**, to include comments associated with the liability model as reflected in the WD. The liability model reflects proposals included in the ED as well as other decisions reached during redeliberations subsequent to the issuance of the Exposure Draft of Proposed Amendments to *IAS 37 Provisions, Contingent Liabilities and Contingent Assets* and *IAS 19 Employee Benefits* in 2005. We also include comments on the IASB Staff Paper, *Recognising liabilities arising from lawsuits* issued on 7 April 2010 (“Staff Paper”).

Insurance entities have a keen interest in the general liability reporting model developed by the IASB as litigation concerning insurance coverage is integral to our business. In particular, the recognition and measurement model for litigation liabilities as well as the potential affects of applying the proposed model to other liabilities, including insurance contracts, are both topics of critical interest to the insurance industry.

In February 2010, the U.S. Securities and Exchange Commission (“SEC”) issued a statement of continued support for a single set of high-quality global accounting standards. The SEC’s statement acknowledged International Financial Reporting Standards (“IFRS”) as being best positioned to serve that role. We note that the IAS 37 liability project is not included on the FASB/IASB convergence agenda nor is a similar project included in the FASB’s current technical plan. The ED states that one of the main aims of the IAS 37 project is to eliminate some differences between IAS 37 and U.S. Generally Accepted Accounting Principles, however the removal of the probability criterion creates a significant difference between the two standards. Convergence, as it relates to the recognition and measurement of liabilities, cannot be achieved if the proposed ED and WD are adopted without modification unless substantial modifications necessary to bring the FASB’s companion standard, formerly referred to as Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies* (FASB Codification Topic 450), into conformity with the ED and WD are proposed, exposed, deliberated and ultimately adopted.

Jerry M. de St. Paer  
**Executive Chair**

Douglas Wm. Barnert  
**Executive Director**

**Group of North American Insurance Enterprises**  
40 Exchange Place, Suite 1707  
New York, NY 10005  
UNITED STATES

++1-212-480-0808  
info@gnaie.net  
www.gnaie.net

The unique nature of the U.S. legal system, which is not expected to change, makes it difficult to apply a global recognition and measurement accounting standard for liabilities and have it produce results consistent with those attained in jurisdictions that possess vastly different legal systems. For reasons more fully discussed in our response, applying the proposed standard in the U.S. would not create transparency but rather confusion.

In addition to the specific issues that we have with the proposed recognition and measurement model, from a procedural standpoint, we also note that the issue of liability recognition is currently being debated in other active joint convergence projects with exposure drafts expected within the next few months. The timing of this project, given that it is not a joint convergence project, should be considered after the related projects are exposed, commented on, and redeliberated by both Boards. Assuming the SEC ultimately moves to incorporate IFRS into U.S. financial reporting, U.S. GAAP reporting entities would be affected by this project which has not otherwise been brought to their attention as potentially affecting the recognition and measurement of general liabilities. Multinational entities are subject to the U.S. litigation environment and therefore the Board has an obligation to determine if the proposals are achievable for those entities.

In terms of specific concerns, we do not believe the measurement requirements in the ED, particularly those which fall under paragraph 36B(a), result in the reporting of financial statement information that is decision useful. Moreover, we believe the recognition criteria in the WD coupled with the measurement criteria result in the recognition of amounts that are not reflective of the expected outflow of financial resources from the reporting entity. We believe the difficulty of applying the recognition and measurement criteria was confirmed by the IASB Staff's need to issue the Staff Paper, which we believe further substantiates preparer concerns that inadequate consideration has been given to the complexities that exist in the U.S. legal system. The mechanics of the proposed model will not only produce measurements that do not reflect the anticipated outflow of financial resources, if any, but may also produce measures that vary widely from period to period. We are concerned that this non-economic variability which is not reflective of the anticipated outflow of financial resources, if any, will not provide decision-useful information to investors or other financial statement users.

In addition to concerns about the measurement criteria, we are also very concerned about modifications made to the recognition threshold; more specifically, the proposed removal of the probability criterion for recognizing a liability. Beyond the practical issues that removing the probability threshold creates there is that basic issue of whether the change is consistent with the Conceptual Framework, and if not, whether it is appropriate to make the modification in the Liabilities Project without reconsidering the Conceptual Framework.

We strongly encourage the IASB to officially re-expose the entire IAS 37 integrated standard. We do not believe constituents can adequately assess the exposure of only the measurement principle and guidance contained in the limited re-exposure proposal without considering the broader implications of both the recognition and measurement criteria; especially due to the fact that the redeliberations related to the recognition criteria did not result in modifications as suggested by the majority of commentators.

GNAIE's detailed comments are organized under the following headings:

- I. Measurement of General Liabilities (i.e., not arising from service contracts)**
- II. Measurement of Liabilities Under Service Contracts**
- III. Answers to questions posed in ED**

\*\*\*\*\*

## I. Measurement of General Liabilities (i.e., not arising from service contracts)

We do not believe the surviving third recognition criterion in Paragraph 2 of the Staff Paper “A reliable estimate can be made of the amount of the obligation” is operable with the requirement to utilize probability weighted cash flows (“PWCFs”) in the ED. Determining PWCFs for single, unique liabilities is inappropriate as it is not statistically reliable due to the universe of potential outcomes not being associated with a normal probability distribution. While litigation lawsuits related to insurance coverages are common in the U.S., each case is unique as insurance entities offer a variety of insurance products (each with its own insurance contract) in potentially 50 different state jurisdictions (class action suits and sets of cases involving the same complaint also involve unique and discrete circumstances). Not only are the contracts and jurisdictional laws unique, clarity does not always exist on whether or not the specifics related to the policyholder’s loss incurred is a covered event under the contract. A covered insurance event is not always indisputable, even for mortality risk insurance products (e.g., special provisions may apply when a death is attributable to suicide).

Reporting entities simply do not have the ability to assess unique litigation liabilities in the manner proposed in the ED. In our experience, both internal and external legal counsel who are trained to assess the facts of a particular case and assess the likelihood of loss based on the facts and the status and results of the legal proceedings are not trained to, nor can they, provide a full probability weighted distribution of potential outcomes for each case. In the U.S., companies would not be able to parameterize the distribution thus making an estimate of probability weighted cash flows statistically invalid. Instead, internal and external legal counsel compile information about the likelihood of a negative outcome and continuously assess both historical and emerging data to determine when an exposure breaches the probable and reasonable loss threshold. Until the recognition threshold is met, the reporting entity only provides disclosures about the legal proceeding to the extent that a loss is reasonably possible. We believe disclosures of the potential risks related to claims and assertions provides the most decision-useful information to investors and other financial statement users until such time as the recognition threshold is breached.

The recognition threshold set forth in the ED is based on the existence of a **present obligation**. Moreover, paragraph 4 of the Staff Paper states, “*An entity has a present obligation only if, and to the extent that, the claim against it is valid.*” Paragraph 8 then states, “*An entity would recognize a liability when applying the new IFRS that it does not recognize when applying IAS 37 only if:*

- (a) **critterion 1 is satisfied**; i.e., available evidence suggests the entity has an obligation to the plaintiff; but
- (b) **critterion 2 is not satisfied**; i.e., the probability of any payment being required to settle the obligation is less than 50 per cent.”

The likely situation is that it would be difficult to substantiate “no present obligation”, i. e., no valid claim exists. The determination of whether or not a claim is valid is not ultimately made by the defendant, but rather the court (which is subject to either the judge’s interpretation of the law, evidence presented and contract provisions or a jury’s assessment of the same). Moreover, assuming the overwhelming majority of plaintiffs who file lawsuits believe they have a valid claim, obtaining a legal opinion that a claim is invalid, which we believe would be the necessary substantiation for no accrual, may not be obtainable in the U.S.

The Staff Paper refers to realistic assessment in paragraphs 12 and 13 which suggests that current assessments may be **unrealistic**. In the absence of a normal probability distribution, which does not exist for general liabilities, introducing requirements to measure the risk of an unique uncertain event will not aid investors understanding of the risk but rather introduce another uncertain measurement to the financial statements that is not reliable, verifiable, comparable, or decision useful. In addition, since legal counsel subject matter experts are unable to determine PWCFs a fundamental building block in the measurement process will not be

obtainable. In the case of discounting, we believe it should only be applied in situations where the timing and amount of cash flows are reliably determinable on an individual liability basis. When this is not the case we do not believe the output represents decision-useful information.

In general we find the recognition model proposed in the ED to be unnecessarily complex which will require reporting entities to perform highly speculative calculations for cash outflows whose likelihood is remote, and will not result in decision-useful, auditable measurements in the financial statements.

## II. Measurement of Liabilities Under Service Contracts

We believe the measurement of liabilities related to service contracts should be consistent with how the contract issuer plans to settle the contract, which in most cases will be on a fulfillment with customer basis. The amount an entity would pay to cancel or transfer an obligation is not typically a relevant measurement alternative for liabilities under the scope of IAS 37. The contract fulfillment value (“CFV”) model that GNAIE supports has the following attributes:

### **Contract Fulfillment Value components:**

- (a) Best estimate of cash flows
- (b) Discounting when the timing and amount of cash flows are reliably estimable on an individual liability basis
- (c) No explicit risk margins (“ERM”) as best estimate cash flows incorporates uncertainty

GNAIE supports the measurement of service contracts (excluding insurance) at an amount that represents the cost of fulfilling the obligation under the contract pursuant to its terms (and not based on the transfer or the obligation to an unrelated party or cancellation of the obligation with the counterparty). With respect to the liabilities in the scope of the ED, utilizing either a four building block model with separate risk and residual margins or a three building model with a composite margin has no history to substantiate its ability to produce information to investors, regulators and others that is reliable, verifiable, comparable, relevant and decision useful. The estimated gross cost of settling the liability should not include a separate risk or profit margin. We believe the use of ERMs inappropriately suggests to investors a level of precision in predicting uncertain future events which is not the case. Because the building block model proposed for fulfillment value is largely statistical in nature, the ability to quantify a relevant and reliable ERM is dependent upon the ability to reliably develop probability weighted cash flows together with associated distributions and probabilities which we do not believe is possible for liabilities covered under the scope of the ED.

1. GNAIE does not support the use of PWCFs due to the nature of the liabilities under the scope of the ED. For most if not all service contracts it is not possible to either identify all possible outcomes or to probability weight them. Moreover, any probabilities assigned cannot be fully tested with sufficient data before the environment changes enough to make the past data irrelevant to estimating the current risk.
2. We do not support the discounting of estimated cash outflows in the measurement of general liabilities except in circumstances where the timing and amount of cash outflows are reliably determinable on an individual contract basis.
3. The ED has not clearly articulated what the risk margin is intended to reflect. That is, we do not believe the requirement to incorporate explicit risk factors in the measurement of service contract liabilities will produce reliable, comparable or decision-useful information. Inputs necessary to develop relevant, reliable, comparable risk margins do not exist.
4. The introduction of profit margins in the measurement of service contract liabilities a reporting entity intends to settle with internal resources is inappropriate. While we understand that choices (such as

settling a liability with internal resources, transferring it to a third party, or exiting it by other means) necessarily involve a range of opportunity costs, those potential costs should not affect the measurement of the liability. In contrast, the measurement should only reflect the manner in which the reporting entity intends to settle the liability. Where settlement with internal resources will occur, no profit margin should be incorporated as that would not reflect an actual cash outflow but rather a subjective hypothetical value related to the opportunity cost of settling the liability with internal resources.

### III. Answers to questions posed in ED

#### **Question 1 – Overall requirements**

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 disagree with the entirety of paragraphs 36A through 36F. Conceptually, the measurement objective underlying 36A through 36F is a transfer or exit value based notion (i.e., fair value) which we believe is only appropriate to apply in situations where a market exists which provides values that a reporting entity (as well as investors and other financial statement users) can use to calibrate and verify the reasonableness of financial statement measurements.

#### **Question 2 – Obligations fulfilled by undertaking a service**

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?

We do not support the inclusion of a profit margin in service contracts that the reporting entity intends to settle with internal resources. While we understand that choices (such as settling a liability with internal resources, transferring it to a third party, or exiting it by other means) necessarily involve a range of opportunity costs, those potential costs should not affect the measurement of the liability. In contrast, the measurement should only reflect the manner in which the reporting entity intends to settle the liability. Where settlement with internal resources will occur, no profit margin should be incorporated as that would not reflect an actual cash outflow but rather a subjective hypothetical value related to the opportunity cost of settling the liability with internal resources.

#### **Question 3 – Exception for onerous sales and insurance contracts**

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 support the exception for onerous insurance contracts. Onerous contracts are in the scope of the proposed IFRS since most are not defined or handled in other literature. Onerous insurance contracts are not otherwise covered by IFRS 4. The IASB was careful to exclude onerous insurance contracts from the scope as they will be handled in the insurance contracts project and we agree that it would be undesirable to go back and change this IFRS when the project is completed.

\*\*\*\*\*