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International
Accounting Standards
Board

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These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: 18 July 2006, London

Project: Amendments to IAS 37 (Agenda Paper 4B)

Amendments to IAS 37: Can recognition of a liability influence the outcome of legal proceedings

INTRODUCTION

1. The recognition principle underlying the ED requires an entity to recognise a liability when the definition of a liability has been satisfied, unless the liability cannot be measured reliably. The liability is measured using an expected cash flow approach, reflecting the amount that the entity would rationally pay to transfer or settle the liability on the balance sheet date. If a range of possible outcomes exist, the entity is also required to disclose information indicating the uncertainties associated with the future cash outflows that will be required to settle or transfer the liability.
2. This paper addresses concerns that applying these principles to a liability, when the facts and circumstances associated with the liability are the subject of a lawsuit, may adversely influence the outcome of legal proceedings. For the purposes of this paper such liabilities are described as “legal claims”.
3. This paper is divided into four sections:
 - a. Summary of recommendations
 - b. Recent Board discussions [*paragraph 5*]

- c. Comment letter analysis [*paragraphs 6 – 10*]
- d. Staff discussion:
 - i. Proposed changes to the IAS 37 recognition and disclosure requirements affecting legal claims [*paragraphs 11 – 15*]
 - ii. Effect of the proposed changes on discovery and visibility of financial information relating to legal proceedings [*paragraphs 16 – 26*]
 - iii. Potential options to prevent discovery of work papers [*paragraphs 27 – 31*]

SUMMARY OF RECOMMENDATIONS

- 4. The staff does not recommend including an exemption for circumstances when recognition of a liability would prejudice the entity (prejudicial recognition exemption) in any final Standard or extending the exemption for disclosure on the grounds of prejudice to the entity (prejudicial disclosure exemption) to include paragraph 67 of the ED's disclosure requirements.

RECENT BOARD DISCUSSIONS

- 5. The ED proposes that the start of legal proceedings creates a liability because an entity is obliged to stand ready to act as the court directs.¹ In June 2006 the Board reconsidered its position and concluded that the start of legal proceedings, in itself, does not obligate an entity. Rather, the start of legal proceedings is another piece of evidence that may be relevant when an entity evaluates whether a liability exists.² The staff notes that respondents' comment letters were received prior to June's Board meeting. Therefore some of the concerns articulated in those letters and analysed in the next section of this paper should be read in this context.

COMMENT LETTER ANALYSIS

- 6. Some respondents are concerned that the conclusion currently in Example 1 of the ED would require an entity to recognise and disclose information about all legal claims at the start of legal proceedings. Often this would be earlier than currently required by IAS 37, especially when the facts and circumstances associated with a legal claim are uncertain or in dispute.
- 7. In many jurisdictions an entity's financial records relating to a legal claim are 'discoverable' as part of the legal process. Therefore some respondents are concerned that the ED's proposal could adversely influence an entity's chance of successfully defending a claim. This is because recognition of a liability may reduce the likelihood of pre-trial dismissal or be viewed by a court or a jury as an admission of guilt.

¹ ED, paragraph 26 and illustrative example 1.

² Refer to agenda paper 3B presented at the June 2006 Board meeting for further detail.

8. Similarly, other respondents are concerned that publishing information about a legal claim in an entity's financial statements may reduce an entity's chance of negotiating a favourable settlement. This is because the other party to the claim or a jury may use an entity's financial records to establish a minimum amount for damages. [One respondent] notes '... even with valid defences, the amount recorded on the balance sheet would become the starting amount for damages to be awarded to the plaintiffs.'
9. Respondents located in jurisdictions in which subsidiary financial statements are placed on the public record are also concerned about the visibility of sensitive information as a result of recognising or disclosing information about legal claims. This is due to the lower materiality thresholds typically applied to subsidiary financial statements compared to consolidated financial statements. This may mean that information about a legal claim which is not visible at group level (due to aggregation of information and higher materiality) might be clearly identifiable in the individual subsidiary financial statements. [A] UK representative group comments '... the "valuation" of claims that are individually immaterial to a large group, may have to be publicly disclosed in subsidiary accounts, whereas an equivalent business based in another jurisdictions (eg the US) may not be required to make any disclosure at all, or be able to aggregate such claims so that individual details can't be identified. This could result in a competitive disadvantage for businesses operating in the UK, compared with those operating overseas.'
10. One respondent³ recommends addressing these issues by extending the prejudicial disclosure exemption in paragraph 71 of the ED to also cover the disclosure requirements of paragraph 67 (see appendix A). The respondent argues that this extension would protect an entity from disclosing sensitive information that might adversely influence the outcome of legal proceedings. But other respondents⁴ disagree and note that the seriously prejudicial exemption will not offer 'sufficient protection in the majority of cases'.

STAFF DISCUSSION

Proposed changes to the IAS 37 recognition and disclosure requirements affecting legal claims

11. In many respects the concerns about the public provision of potentially sensitive information resulting from legal claims are not new. Existing preparers of IFRS financial statements already provide potentially sensitive information about legal claims, whether that information is limited to disclosure or not. SEC registrants preparing financial statements in accordance with US GAAP are also required to disclose specific details about material legal proceedings.⁵
12. Similarly, questions about when and how to report information about legal claims are not new. The *Framework* provides guidance on measurement uncertainty, but

³ Footnote omitted from observer notes

⁴ Footnote omitted from observer notes

⁵ SEC regulation S-K, item 103 requires disclosure of more information than IAS 37.

- does not refer to element uncertainty. The current IAS 37 provides limited guidance on how to address element uncertainty but this guidance was not carried forward to the ED. The Board has already acknowledged that any final Standard will need to include some guidance on how to address element uncertainty, although the extent and form of that guidance remains work in progress.⁶
13. So what has changed? The staff agrees that the ED's proposals would have resulted in earlier recognition of some liabilities. However, the Board's conclusion that the start of legal obligations does not, in itself, obligate an entity is likely to partially alleviate respondents' concerns about earlier recognition of liabilities for legal claims. But the Board has tentatively affirmed its proposal to omit the probability recognition criterion from any final Standard.⁷ This is an important change.
14. Currently, an entity may conclude that it has a present obligation because its past actions have violated a law or breached a contract. But if it is not probable that an outflow of resources will be required to settle the obligation, no liability is recognised. Instead, information about the present obligation is disclosed in the notes to the financial statements. Anecdotal evidence suggests that some entities currently delay recognising a liability for a legal claim until it is reasonably certain that an outflow of resources will be required to settle the claim⁸ - ie the ultimate outcome of legal proceedings is used to identify and recognise a liability, not the existence of a present obligation. In contrast, following redeliberations, any final Standard would require recognition of a liability when an entity is reasonably certain that its past actions have violated a law or breached a contract – ie when a present obligation exists. Probability of a future outflow no longer plays a role in determining whether a liability is recognised.
15. There has also been a small change to the disclosure requirements. Paragraph 92 of IAS 37 includes a prejudicial disclosure exemption. This allows entities to replace detailed disclosure about legal proceedings with a general description of the dispute and an explanation of why detailed information has not been disclosed. The prejudicial disclosure exemption has been carried forward to paragraph 71 in the ED (for reference the ED's disclosure requirements are provided in appendix A to this paper). But, whereas the prejudicial disclosure exemption in IAS 37 covers *all* disclosure requirements, the ED's prejudicial disclosure exemption excludes paragraph 67. Therefore, the ED requires disclosure of the carrying amount of the liability at the period end together with a description of the nature of the obligation for each class of recognised liability.

⁶ Refer to agenda paper 10C presented at the May 2006 Board meeting.

⁷ Refer to agenda paper 3A presented at the June 2006 Board meeting.

⁸ This anecdotal evidence is supported by the findings included in section E1 of the *SEC Report & Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 on Arrangements with Off Balance Sheet Implications, Special Purpose Entities and Transparency of Filings by Issues* and by a PwC article in the April edition of *CFO Direct Coming Distractions: Eight Looming Risks*. The staff acknowledges that these findings are based on a review of entities preparing financial statements in accordance with US GAAP rather than IFRS and therefore these findings are not a representative sample of IFRS constituents.

Effect of the proposed changes on discovery and visibility of financial information relating to legal proceedings

What financial information is 'discoverable'?

16. The objective of discovery is to ensure that all parties go to trial with as much knowledge as possible and that neither party should be able to keep secrets from the other⁹. Discovery can take many forms. Legal dictionaries define electronic discovery as “review and production of evidentiary material for litigation stored in electronic format. This may include e-mail, word processing, spreadsheets, databases and presentations”¹⁰. The staff understands that an entity’s published financial statements and its supporting work papers (electronic or otherwise) used to prepare the information contained therein are both discoverable as part of the legal process in many jurisdictions. Both sources of discoverable information will be considered separately.

Discovery & visibility of information in an entity’s financial statements

17. The staff thinks that the effect of the changes proposed in the ED on the amount of information about legal proceedings included in an entity’s financial statements would be limited.
18. First, the staff thinks that respondents’ concerns about information included in an entity’s financial statements can be limited to recognition and disclosure of single legal claims. The staff agrees that this situation is most likely to arise in small entities or subsidiary entities preparing individual financial statements, but may affect larger entities too. This is because small and subsidiary entities are more likely to have one material legal claim which is clearly identifiable in the balance sheet and in the notes to the financial statements.
19. In contrast, larger companies and consolidated groups are more likely to have a number of similar legal claims which may be aggregated into one class for financial reporting purposes. Thus, information about a single claim is not visible in either the balance sheet or the ‘provisions’ note accompanying the financial statements. For example, an entity recognising total ‘provisions’ of \$1,000,000 in its balance sheet might disclose in the notes to the financial statements that \$700,000 of the total provision recognised relates to product liability legal claims, \$50,000 relates to other legal claims and \$250,000 relates to the entity’s asset retirement obligations.
20. Secondly, the staff questions whether the exclusion of paragraph 67 from the ED’s prejudicial disclosure exemption will significantly increase the amount of information available about single legal claims in an entity’s financial statements. Paragraph 67 of the ED requires disclosure of the carrying amount of the liability at the period end together with a description of the nature of the obligation for each *class* of recognised liabilities. Consider the example of an entity which

⁹ Source: www.dictionary.law.com

¹⁰ Source: www.legal-definitions.com

recognises total ‘provisions’ of \$100,000 in its balance sheet relating to a single legal claim. [Remainder of paragraph omitted from observer notes]

21. [Paragraph omitted from observer notes.]
22. Lastly, the staff questions the ability of the plaintiff to use the information provided in an entity’s financial statements to influence ongoing legal proceedings, even if a single legal claim is the only material liability. An ability to use the financial statements to influence the outcome of legal proceedings assumes that the plaintiff knows that it is the only party which has made a claim against the entity. Careful wording in the notes to the financial statements could ensure that this fact would not be readily ascertainable from the financial statements as a standalone document. Rather the plaintiff will only be able to identify this fact by gaining access to an entity’s internal work papers supporting the information included in the financial statements.

Discovery & visibility of information in an entity’s supporting work papers

23. The staff thinks that respondents’ concerns about discovery of an entity’s supporting work papers can be limited to recognised single legal claims.
24. As noted above, the ED’s proposal to omit the probability recognition criterion means that previously unrecognised legal claims will now be recognised, necessitating the preparation of additional supporting work papers (ie for the purposes of measurement). The ED does not change the status quo for legal claims which are already recognised in accordance with IAS 37.¹¹ Recognition may occur before out of court settlement negotiations or court proceedings have been concluded. Logically, one would expect that work papers relating to recognised claims are already discoverable (although in this instance, respondents’ comments may highlight an existing issue about the discovery of work papers for liabilities currently recognised under IAS 37 and therefore should not be dismissed without consideration).
25. The staff does not think that respondents’ concerns about discovery apply to a expected cash flow calculation for a portfolio of legal claims. This is because it is likely that a portfolio of similar obligations will be assessed, measured and reported on a total basis. As a result, an entity’s assessment and measurement of each individual claim is not readily apparent in the supporting work papers. (As an aside, the staff notes that portfolios of legal claims are rare because most material legal disputes are unique and class actions are not permitted in several jurisdictions.)

Conclusion

26. Based on the analysis above the staff thinks that respondents’ concerns about the discovery and visibility of financial information relating to legal proceedings can be narrowed down to recognised, single legal claims. These claims may be visible in an entity’s financial statements. But the staff thinks that careful

¹¹ IAS 37 already requires an entity to recognise a liability for a single legal claim when a present obligation exists and an outflow of economic benefits is probable.

wording combined with the prejudicial disclosure exemption means that the information included in the financial statements alone will not be sufficient to influence the outcome of legal proceedings. Therefore, it is discovery of work papers supporting a single legal claim recognised in the financial statements that is the primary source of concern.

Potential options to prevent discovery of work papers

27. The staff thinks that a prejudicial *recognition* exemption would be the only way to prevent discovery of financial information relating to a single legal claim. This is because a prejudicial recognition exemption would mean that an entity need not prepare an expected cash flow calculation, hence there would be no work paper to discover.
28. This, in our view, is not a viable option. A recognition exemption would decrease the amount of useful information made available compared to the current IAS 37 and favours preparers over users of financial statements. Moreover, the staff is not aware that discovery of information relating to liabilities recognised in accordance with the current IAS 37 has adversely influenced the outcome in a sufficient number of lawsuits to warrant an exemption to the recognition principle¹².
29. Secondly, the staff also notes that respondents' concerns may be partly alleviated by the Board's conclusion in June 2006 that the start of legal proceedings, in itself, does not obligate the entity. This is because this conclusion is likely to reduce the number of additional legal liabilities which would be recognised earlier as a result of the ED.¹³
30. Thirdly, the staff observes that discovery is a legal process. Extending discovery to include information which is not publicly available (such as an entity's internal work papers) and the use of that information in legal proceedings is a legal issue, not a financial reporting issue. The IASB's role is to establish the extent and nature of information to be included in publicly available financial statements. The IASB does not have the ability to influence legal proceedings.
31. Consequently, staff does not recommend including a prejudicial recognition exemption in any final Standard.

¹² That is to say, the limited number of respondents who comment on this issue indicates this is not a pervasive issue and the staff is not aware of any requests for a recognition exemption presented to IFRIC or other interpretive bodies.

¹³ Although note the staff recommendation in agenda paper 4A which would require an entity to disclose information about possible obligations.

APPENDIX A: The ED's disclosure requirements

Disclosure

- 67 For each class of recognised non-financial liability, an entity shall disclose the carrying amount of the liability at the period-end together with a description of the nature of the obligation.**
- 68 For any class of recognised non-financial liability with estimation uncertainty, an entity shall also disclose:**
- (a) a reconciliation of the carrying amounts at the beginning and end of the period showing:**
 - (i) liabilities incurred;**
 - (ii) liabilities derecognised;**
 - (iii) changes in the discounted amount resulting from the passage of time and the effect of any change in the discount rate; and**
 - (iv) other adjustments to the amount of the liability (eg revisions in estimated cash flows that will be required to settle it).**
 - (b) the expected timing of any resulting outflows of economic benefits.**
 - (c) an indication of the uncertainties about the amount or timing of those outflows. If necessary to provide adequate information, an entity shall disclose the major assumptions made about future events, as described in paragraph 41.**
 - (d) the amount of any right to reimbursement, stating the amount of any asset that has been recognised for that right.**
- 69 If a non-financial liability is not recognised because it cannot be measured reliably, an entity shall disclose that fact together with:**
- (a) a description of the nature of the obligation;**
 - (b) an explanation of why it cannot be measured reliably;**
 - (c) an indication of the uncertainties relating to the amount or timing of any outflow of economic benefits; and**
 - (d) the existence of any right to reimbursement.**
- 70 In determining which non-financial liabilities may be aggregated to form a class, an entity considers whether the nature of the items is sufficiently similar for a single statement about them to fulfil the requirements of paragraphs 67-69. Thus, it may be appropriate to treat as a single class of non-financial liabilities amounts relating to warranties of different products, but it would not be appropriate to treat as a single class amounts relating to normal warranties and amounts subject to legal proceedings.**
- 71 In extremely rare cases, disclosure of some or all of the information required by paragraphs 68 and 69 can be expected to prejudice seriously the position of the entity in a dispute with other parties on the subject**

matter of the non-financial liability. In such cases, an entity need not disclose the information, but shall disclose the general nature of the dispute, together with the fact that, and reason why, the information has not been disclosed.