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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: 20 June 2006, London

Project: Amendments to IAS 37

Subject: Revisiting lawsuits (Agenda Paper 3B)

INTRODUCTION

1. Almost all respondents use litigation to illustrate their concerns about implementing the proposals in the ED. As noted at the May 2006 Board meeting, the staff thinks that litigation is particularly problematic because litigation often includes multiple aspects of uncertainty. That is to say, respondents' concerns relating to litigation combine issues associated with the recognition principle, the measurement principle and the disclosure requirements of the ED. This paper considers issues associated with the ED's recognition principle only.
2. The ED's recognition principle requires an entity to recognise a liability when (a) the definition of a liability has been satisfied, and (b) the liability can be measured reliably. This paper focuses on the first aspect of this principle - whether the definition of a liability has been satisfied.
3. This paper is the first of two papers discussing how the ED's recognition principle applies to lawsuits. The purpose of this paper is to (a) identify and analyse respondents' concerns about litigation, and (b) reconsider the conclusion in Examples 1 and 2 which illustrate how to apply the ED's

recognition principle to litigation. The staff acknowledges that this paper raises challenging issues for developing guidance to assist entities in applying the ED's recognition principle in the context of lawsuits (and similar regulatory actions). But this paper does not discuss the extent or form of any additional guidance. This will be considered in a second paper, to be presented to the Board in July. Before we consider the extent and form of any additional guidance, the staff seeks the Board's views on the staff conclusions in this paper.

4. This paper is structured as follows:
 - (a) Summary of conclusions
 - (b) A reminder of Examples 1 and 2 in the ED
 - (c) Comment letter analysis
 - (d) Staff discussion
 - (i) Examples 1 and 2 are contradictory
 - (ii) Over simplification of a complex problem
 - (iii) Reconsidering the conclusions in Examples 1 and 2
 - (e) Next steps

SUMMARY OF CONCLUSIONS

5. The staff concludes that:
 - (a) Examples 1 and 2 in the ED are contradictory. *[paragraph 28]*
 - (b) the illustrative examples accompanying any final Standard need to include additional guidance on how to address 'element uncertainty' in the context of legal proceedings (and similar regulatory actions).
[paragraphs 29 – 30]
 - (c) the likelihood that an external party will detect an entity's violation of the law or breach of contract is not relevant in determining whether the definition of a liability is satisfied. *[paragraphs 33 - 40]*

- (d) the start of legal proceedings does not obligate an entity. [paragraphs 47 -59]

A REMINDER OF EXAMPLES 1 AND 2

6. In Example 1 (disputed lawsuit) an entity is being sued for allegedly selling harmful food. The entity disputes that it sold harmful food and its lawyers advise that the entity is unlikely to be found liable. Nonetheless, the Example concludes that the start of legal proceedings has given rise to a liability. The ED argues this is because the start of legal proceedings obliges the entity to stand ready to perform as the court directs. The ED also notes that even if the entity expects it will not be found liable, no other party would assume the obligation on the balance sheet date without being compensated by the entity.
7. In Example 2 (potential lawsuit) a patient dies as a result of a mistake in an operation. The hospital is aware of the mistake. Legal proceedings have not started. The Example concludes that hospital has a liability as a result of the operation in which negligence occurred.
8. For reference, Examples 1 and 2 are included as an appendix to this paper.
9. The Board's conclusion in Example 1 results from analysis of items previously described as contingent liabilities into conditional and unconditional obligations. The Board noted that the possibility of payout in a legal claim is a conditional obligation (dependent upon the court's judgement) and concluded that the start of legal proceedings could be viewed as giving rise to an unconditional obligation. However, the Board wanted to emphasise that an entity did not necessarily wait until the start of legal proceedings before recognising a liability. If the entity was aware that it had violated a contract or the law, it should recognise a liability. Hence, Example 2 was developed to illustrate this point.

COMMENT LETTER ANALYSIS

Examples 1 and 2 are contradictory

10. Many respondents think that Examples 1 and 2 in the ED are contradictory. This is because Example 1 concludes that the start of legal proceedings is the obligating event. Whether the underlying disputed event (selling harmful

food) occurred appears to be irrelevant in determining whether the entity has a liability. In contrast, in Example 2 it is the underlying event (negligence in an operation) that is the obligating event. The possibility of legal proceedings appears to be irrelevant in determining whether the hospital has a liability.

11. Some respondents question why, in Example 1, it is the start of legal proceedings, rather than the fact that ten people died as a result of an error by the company, which creates the legal obligation. For example [one respondent] comments "...a stand ready obligation arising as a result of legal liability is recognised when the event giving rise to the legal liability occurs, not when the entity becomes party to legal proceedings. ..." These respondents note that the conclusion that selling harmful food is the obligating event is more consistent with Example 2, which identifies the hospital's mistake as the obligating event rather than notice that legal action is to be taken.

Over simplification of a complex problem

12. Other respondents comment that the legal examples in the ED over simplify a complex problem. These respondents note that the examples assume the unconditional obligation is always known with certainty. In Example 2, the hospital knows its mistake caused the patient to die and it is highly likely that the patients' relatives will sue and a court would find the hospital guilty of negligence. In Example 1, the start of the lawsuit gives rise to a stand ready obligation. Therefore, the ED discusses uncertainties with respect to the conditional obligation, but does not provide any guidance on how to deal with uncertainties surrounding the unconditional obligation ('element uncertainty'¹). [One respondent] notes that "it is easy to imagine the hospital [in Example 2] being faced with a slightly different situation, ie a patient has died during an operation, but the hospital cannot be sure whether death occurred as a result of a mistake being made in the operation. In this case, it is not clear whether an unconditional obligation actually exists, although the possibility of there being an unconditional obligation cannot be ruled out".

¹ Please refer to agenda paper 10C presented at the May 2006 Board meeting for further discussion of element uncertainty.

13. Example 1 explains that until legal proceedings were started the entity was not aware that it may have sold harmful food. One respondent² therefore suggests that the start of legal proceedings is simply a pragmatic means of resolving uncertainty and confirms the existence of a previously unknown liability.

Disagree with the conclusion in Example 1

14. Many respondents disagree with the conclusion in Example 1 that the start of legal proceedings gives rise to a stand ready obligation to act as the court directs.

Determining whether a liability exists should be based on an evaluation of all available evidence

15. Some respondents argue that in a legal dispute (when it is not certain that wrong doing has occurred), there is no single obligating event that confirms the existence of a liability. Rather, an entity must determine whether a liability exists based on all of the available evidence at the balance sheet date. Indeed these respondents emphasise that there is often a long chain of uncertain events before the existence of a liability is confirmed. For example, one respondent³ notes that "... between the point at which an event occurs that is said to give rise to a claim and a final judgment, there are likely to be a number of important turning points ... but these turning points will differ both in substance and significance from case to case ...". In Example 1 the entity disputes that it sold harmful food at the time its financial statements are authorised for issue. Therefore these respondents conclude that, in this Example, the start of legal proceedings does not provide sufficient evidence to confirm that a liability exists. These, respondents note that the start of legal proceedings in itself does not remove uncertainty that the required obligating event (selling harmful food) has occurred.
16. Secondly, several respondents argue that is it not appropriate to disregard management's assessment of the likely outcome of the case and the nature of the case itself when determining whether a legal obligation exists. This is particularly emphasised by respondents based in the US who point out that the filing of frivolous legal claims is a part of doing business. These respondents

² [Footnote omitted from observer notes]

³ [Footnote omitted from observer notes]

are concerned that failing to take the management's assessment of the case into account when determining whether a present obligation exists may result in the recognition of *possible* obligations – ie items which do not meet the *Framework's* definition of a liability.

17. Some respondents think that the Board has mis-applied the notion of a stand ready obligation to litigation. These respondents question whether an obligation to stand ready to perform as the court directs does require an outflow of resources in the form of services provided by the defendant. For example, [one respondent] says "...Conceivably, a service provided as a result of legal proceedings having started might relate to the complainant receiving the benefit of having its case handled in a way that ensures impartiality and conformity with applicable law ... However, such a service would not be provided by the entity, but by the legislator or the legal framework in which the entity operates".

No legal obligation exists until the court has ruled against the entity

18. Some respondents argue that in a legal dispute (when it is not clear that wrong doing has occurred), it is the role of the court to establish the facts and make an order based on the relevant law. Therefore until the final court of appeal makes an adverse court judgment, or final settlement is agreed between the litigating parties, no liability exists.
19. This view is echoed by some respondents to the FASB Invitation to Comment *Selected Issues Relating to Assets and Liabilities with Uncertainties*. These respondents question whether the obligation to stand ready in a legal context represents an outflow of resources until such time the court has ruled against the defendant. These respondents suggest that legal situations are different from contractual situations because (a) no value has been exchanged, and (b) the entity will actively seek to avoid an adverse court judgment and thus avoid any future outflow of resources. These respondents think that if the entity were to settle or transfer the obligation to a third party today, it would settle or transfer the *conditional* obligation not the stand ready obligation.
20. Other respondents argue that no legal obligation exists until the court has ruled against the entity because they perceive a contradiction between Example 1 and the ED's guidance on new legislation which states that a present

obligation only exists when a new law is substantively enacted. For example,[one respondent] comments that “... we find this [the conclusion in Example 1] difficult to reconcile with the situation ... where causing contamination in the past for which expected government legislation will impose a clean-up cost does not constitute an obligating event, even if the new legislation is highly probable of being enacted. It appears to us that, in both situations, the entity has to stand ready to perform: either as the court directs or as the government directs. ...” Similarly, many respondents agree with the alternative view articulated in paragraph AV5 of the ED that it is not clear why an entity’s previous actions that made it vulnerable to the consequences of a possible change in law (which the entity has little, if any, discretion to avoid) do not create an unconditional obligation⁴.

Costs of defending a lawsuit

21. The measurement note accompanying Example 1 states that “even if the entity expects that it will not be found liable, no other party would assume the obligation on the balance sheet date without being compensated by the entity. *This is because of the costs involved in defending the lawsuit* and the risk of an adverse outcome” (emphasis added). The measurement guidance include in Example 1 goes on to states that in measuring the liability, the entity must consider factors such as the cash flows associated with the possible outcomes of the lawsuit, including costs associated with the lawsuit.
22. As a result of the above, some respondents think Example 1 requires an entity to recognise an accrual for at least the costs of defence at the start of legal proceedings. But several respondents question whether this was the Board’s intention and request clarification. For example, [one respondent] notes “... it is unclear whether legal costs are accrued irrespective of the expected outcome of the lawsuit ... it would be helpful to develop a consistent approach regarding whether lawsuits create a present obligation in respect of incremental legal costs that will be incurred to defend or settle the claim ... IAS 37 is silent as to whether these legal costs should be provided when the claim is made or treated as an operating costs when incurred ... This then

⁴ This is particularly true in common law jurisdictions where the judgment of the court *creates* the law. This is relevant in a ‘test’ case when an entity voluntarily goes to court to seek clarification about clarification on an existing law.

raises the question of whether the cost of defending legal claims arise from the same past event as that which gave rise to the lawsuit ...”

23. Others perceive an anomaly between the guidance on legal costs in Example 1 and the prohibition on the recognition of future operating losses articulated in paragraph 52 of the ED. Therefore these respondents oppose recognising a liability for the costs of defence (if this was the Board’s intention) at the start of legal proceedings.

Disagree with the conclusion in Example 2

24. Most respondents focus their analysis on the perceived contradiction between Examples 1 and 2 and rebut the conclusion in Example 1. Few question that a liability arises in Example 2 from the hospital’s mistake. The absence of comment implies that most respondents agree with the conclusion in Example 2.
25. But as noted above, some respondents argue that the existence of a liability must be based on an assessment of all available evidence at the balance sheet date. Therefore a few respondents question whether certainty that a past action or event breaches an existing contract or violates a law, by itself, satisfies the definition liability.
26. In Example 2 these respondents argue that no present obligation exists until the patient’s relatives take legal action against the hospital. This is because the hospital cannot be compelled to admit negligence (even though the hospital is certain that its mistake caused the patient to die). Equally, the absence of compulsion to admit negligence means there is no risk of an outflow of economic benefits until the hospital’s error is detected. Consequently, these respondents conclude that, in Example 2, the hospital has a *possible* obligation at the balance sheet date. Indeed, one respondent notes that recognising a liability before wrong doing has been detected and when it is not probable the entity will be found liable is inconsistent with commercial reality and has the potential to release commercially sensitive information to third parties.

STAFF DISCUSSION

27. The staff thinks that determining whether the definition of a liability has been satisfied in a legal dispute is one of the most difficult areas of liability recognition under IAS 37. This is due to both the inherent uncertainty in the judicial process itself and uncertainty about the facts and circumstances relating to the alleged violation of the law. Currently IAS 37 requires an entity to exercise judgment, particularly focusing on whether a present obligation exists. The staff thinks that the volume and nature of respondents' comments in the letters received demonstrates that determining whether the definition of a liability has been satisfied in a legal dispute truly is a difficult area and that additional guidance is needed. Therefore the staff thinks it is difficult to avoid providing additional guidance on how to apply the ED's recognition principle to litigation in any final Standard.

Examples 1 and 2 are contradictory

28. As noted in paragraph 9, the staff thinks that Examples 1 and 2 were developed to illustrate different points arising from the Board's initial deliberations. Therefore the conclusions in Examples 1 and 2 are not intended to be contradictory. However, based on the analysis of comment letters in paragraphs 10 and 11, it is difficult to argue that the conclusions in Examples 1 and 2 are consistent. This suggests that the conclusion in one, or both, of the examples is wrong.

Over simplification of a complex problem

29. In May 2006 the Board discussed 'element uncertainty' and agreed that determining whether an item satisfies the definition of a liability can be difficult⁵. But Examples 1 and 2 essentially eliminate element uncertainty. That is to say, in Example 2 there is no uncertainty that the hospital's error caused the patient to die. In Example 1, there is no uncertainty that a liability exists because the example concludes that the start of legal proceedings obligates the entity to stand ready to act as the court directs.
30. But the staff thinks that element uncertainty often arises from litigation. This is because a legal dispute may indicate that (a) the occurrence of a past event is

⁵ Please refer to agenda papers 10C and 10D presented at the May 2006 Board meeting.

uncertain, and (b) more than one credible interpretation of a law or regulation exists relating to a certain past event⁶.

Reconsidering Examples 1 and 2

31. In light of the perceived contradiction between Examples 1 and 2 and the absence of guidance on how to address element uncertainty in the context of lawsuits (and similar regulatory actions), this section of the paper reconsiders the conclusions in Examples 1 and 2, starting with Example 2.
32. The staff's analysis is based on the *Framework's* definition of a liability. The *Framework* defines a liability as 'a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits'. In May 2006 the Board confirmed that the phrase 'expected to' in this definition is *not* intended to imply that a particular degree of certainty is required before an item meets the definition of a liability⁷.

⁶ Please refer to paragraph 13 of agenda paper 10C presented at the May 2006 Board meeting for further discussion of situations when element uncertainty may arise.

⁷ Refer to the May 2006 board papers, agenda paper 10B.

Reconsidering Example 2

33. In Example 2 the hospital is certain that its mistake caused the patient's death, but it is not certain that the patient's relatives will detect the mistake and start legal proceedings against the hospital. Therefore this section of the paper considers whether external detection of wrong doing is required before a present obligation exists.
34. The *Framework* states that present obligations arise from past events⁸. Paragraph 13 of the ED explains that for a past event to give rise to a present obligation, the entity must have little, if any, discretion to avoid settling it⁹. The staff argues that an entity has little, if any, discretion to avoid the consequences of violating a law or breaching a contract because a court can enforce that law or contract. Therefore a present obligation exists, even if that obligation has not been detected by an external party.
35. Applying this to the fact pattern in Example 2: there is no uncertainty that the hospital's mistake caused the patient to die. Equally, there is no uncertainty that the hospital's mistake resulted from negligence (violating a law¹⁰). Therefore the hospital has little, if any, discretion to avoid the risk that its mistake may be detected by a third party requiring payment of financial compensation to the patient's relatives. Equally the hospital would have to pay a third party to assume the risk of detection and payment of compensation.
36. Those who disagree with the staff's view would argue that the hospital may have a *moral* obligation to admit negligence, but this does not mean that a present obligation exists for financial reporting purposes. Until the patient's relatives detect the hospital's negligence *and* decide to start legal proceedings the hospital cannot be compelled to admit culpability and there is no risk it will be required to pay compensation. Therefore no present obligation exists.
37. But the staff does not agree. The staff thinks that the relatives' detection of the mistake and their decision to seek compensation are uncertain future events. The hospital is unable to unilaterally prevent these events from

⁸ *Framework*, paragraph 63.

⁹ A similar explanation is also included in the current IAS 37, paragraph 17.

¹⁰ A written law (in a code law jurisdiction) or committing a tort (violating an unwritten law or case law in a common law jurisdiction),

occurring. Therefore, the hospital has an unconditional obligation, regardless of detection. The staff thinks that detection and the likelihood that the patient's relatives will start legal proceedings should be reflected in the measurement of the present obligation created by the hospital's mistake, but should not preclude recognition.

38. In determining whether an entity has a present obligation, the staff thinks it is useful to consider whether a counterparty has an enforceable right to assets of another entity at the balance sheet date¹¹. That is to say, if one entity has a present obligation, another entity has a present right. The staff thinks certainty that the counterparty has suffered harm does establish an enforceable right of the counterparty to the assets of the entity that caused harm. Again, applying this conclusion to Example 2: the patient's relatives are the counterparty. Importantly, in this example, the hospital knows it has broken the law by acting negligently in the operation. Therefore the patient's relatives have a legally enforceable right to receive compensation as a result of the hospital's negligence.
39. Opponents of this view would argue that the patient's relatives do not have an enforceable right to the hospital's assets (ie to receive compensation) until they are aware of the hospital's negligence *and* decide to seek compensation. But the staff thinks an enforceable right does exist. It simply has not been detected yet.
40. Based on the analysis above, the staff concludes that the likelihood that an external party will detect an entity's violation of the law or breach of contract is not relevant in determining whether a present obligation exists. Therefore Example 2 is correct because it identifies that the event giving rise to a present obligation is the violation of a contract, law or regulation.
41. **Does the Board agree?**
42. However, following its conclusion, the staff thinks that the wording in Example 2 requires modification to clarify that the risk of such a violation being detected does not affect the conclusion that a liability exists (which, if it

¹¹ The staff notes that in most jurisdictions everyone has a right to pursue legal proceedings. But importantly, a counterparty does not have an enforceable right to the assets of a company unless wrong doing has occurred, the court rules in the counter party's favour, or an entity irrevocably commits itself to transferring its assets to the counter party.

can be measured reliably should be recognised). This is because the fact pattern in Example 2 explains that the hospital considers it ‘highly likely’ that the patient’s relatives will start legal proceedings and that a court would find the hospital guilty of negligence. This could suggest that it is the likely ultimate outcome of the case or that it is the combination of negligence and the high likelihood of legal proceedings rather than the violation of a law that creates a present obligation.

Consistency with the Board’s previous discussions on when and why an event gives rise to a present obligation

43. The staff thinks that its conclusion that external detection of an entity’s violation of the law or breach of contract is not relevant in determining whether a present obligation exists is consistent with the Board’s discussions in May 2006¹² on when and why an event gives rise to a present obligation. In May 2006 the Board considered two examples. The first example was an entity selling CD players without a product warranty but subject to product liability legislation. The second example was a construction company with a known hazard on its building sites, in breach of health and safety regulations.
44. In the first example, the general consensus of opinion was that an entity has a present obligation to repair CD players which are faulty at the point of sale. This is because selling faulty CD players violates the product liability legislation. From a practical perspective an entity will be able to reasonably estimate the number of faulty CD players sold (based on objective evidence provided by past experience, the product’s history and other evidence available, for example) thereby establishing, with reasonable certainty, that a present obligation exists.
45. In the second example discussed at the May 2006 Board meeting, the consensus of opinion was that the existence of a hazard creates a present obligation. This is because the existence of a hazard breaches health and safety regulations. Therefore, if the hazard is not or cannot be rectified, then the construction company has a stand ready obligation to accept the financial consequences of future accidents caused by the hazard. This is consistent with the staff’s conclusion because it is the hazard (knowledge of a breach of

¹² Please refer to agenda paper 10D presented at the May 2006 Board meeting.

contract or violation of a law) which gives rise to a present obligation, not future accidents (“detection”). In measuring its liability the construction company considers (a) the expected period of time until the hazard is rectified, and (b) the likelihood of an accident being caused by the hazard. In the same way, in Example 2 the hospital reflects the likelihood that the patient’s relatives will detect the hospital’s mistake and will seek compensation in measuring its liability.

46. The staff acknowledges that it still has much work to do on refining its analysis and explanation of when and why an event gives rise to a present obligation. But *prima facie*, the staff does not think its conclusion in paragraph 40 of this paper contradicts the Board’s previous discussions on when and why a present obligation exists.

Reconsidering Example 1

47. In this section of the paper, the staff reconsiders the conclusion in Example 1 - that the start of legal proceedings gives rise to a present obligation, even though it remains uncertain whether an obligating event has occurred (ie that the entity served harmful food).
48. First, the staff considers whether the start of legal proceedings confirms the entity did serve harmful food and therefore resolves uncertainty about the facts relating to the claim against the entity. Secondly, the staff considers whether the start of legal proceedings in itself gives rise to a present obligation (regardless of whether a present obligation exists relating to the subject matter of the lawsuit).

Does the start of legal proceedings resolve uncertainty about the facts relating to the claim?

49. The staff thinks that the start of legal proceedings does not resolve uncertainty about the facts relating to the claim. In Example 1 the start of legal proceedings does not resolve uncertainty about whether the entity served harmful food at a wedding and that this food caused the death of ten guests. At the balance sheet date the entity continues to dispute this fact therefore it is not certain that an obligating event has occurred. But Example 1 concludes the start of legal proceedings gives rise to a present obligation. This suggests

that the start of legal proceedings in itself gives rise to a present obligation (regardless of whether a present obligation exists relating to the subject matter of the lawsuit).

50. The staff agrees with respondents who argue that determining whether a present obligation exists for the underlying claim should be based on an evaluation of all known evidence. The staff notes that the *Framework's* definition of a liability states that a present obligation arises from past *events* (as opposed a singular past *event*). Therefore the staff argues that the start of legal proceedings is just one of a number of different facts, all of which should be taken into account when determining whether a present obligation exists. In Example 1, the start of legal proceedings may be the first time that an entity is aware that it may have violated the law, but as a standalone event, the start of legal proceedings does not provide sufficient evidence to conclude that a present obligation exists. This approach is also consistent with the guidance in paragraph 16 of the ED (carried forward from the current IAS 37) which states that an entity must take into account all available evidence when determining whether a liability exists at the balance sheet date.
51. In determining whether an entity has a present obligation for the claim itself, the staff thinks it is also useful to consider whether the plaintiff has an enforceable right to assets of the defendant at the balance sheet date. In many jurisdictions everyone has the right to initiate legal proceedings and the right to have a case independently adjudicated by the court. But the defendant has an equal right to have its arguments heard by the court. Therefore the staff concludes that where there is element uncertainty it is not clear that the plaintiff has an enforceable right to assets of the defendant. Applying this conclusion to Example 1: at the balance sheet date the plaintiff is unable to categorically prove that (a) the entity did serve harmful food at the wedding, (b) it was food poisoning that caused the death of 10 guests, and (c) food poisoning was caused by harmful food eaten at the wedding (whether served by the entity or not). Therefore the plaintiff has no enforceable right to the assets of the entity at the balance sheet date.

Does the start of legal proceedings, in itself, give rise to a present obligation? (regardless of whether a present obligation exists relating to the subject matter of the lawsuit)

52. The staff acknowledges that the argument that the start of legal proceedings, in itself, requires recognition of a liability is attractive. Proponents in favour of this conclusion note the following:
- The start of legal proceedings is a clear event which burdens the entity.
 - An entity has no discretion to avoid the lawsuit – it must either negotiate an out of court settlement or accept the risk of an adverse court judgment. As a minimum, it is virtually certain that an entity will incur legal costs in settling a lawsuit, even the most frivolous claim. Ultimately, no actual cash outflow may be required to settle the claim. For example, the plaintiff may drop the lawsuit or the court may find in favour of the entity and instruct the plaintiff to pay reasonable legal costs of the defendant. But the entity is unable to unilaterally influence either of those possible future events; therefore it is inappropriate to look to the ultimate outcome to confirm the existence (or non-existence) of a present obligation *today*.
 - An entity would have to pay a third party to assume the uncertainty associated with either settlement or an adverse court judgment created by the start of legal proceedings. This provides evidence that an identifiable economic event has occurred.
53. But the staff does not think the start of legal proceedings gives rise to a present obligation, even for the additional legal costs to settle a claim. The staff has reached this conclusion by asking for what, and to whom, is the entity obligated when legal proceedings begin?
54. The staff acknowledges that an entity would have to pay a third party to assume the uncertainty associated with either settlement or an adverse court judgment (either as part of, or separate to, a business combination). But the staff thinks payment to transfer an uncertainty associated with legal proceedings does not mean that the start of legal proceedings satisfies the definition of a liability. Rather, the staff agrees with respondents who argue

that an entity would be paying to a transfer the uncertainty associated with a *possible* obligation created by the start of legal proceedings. The staff thinks that this conclusion is consistent with the ED's guidance on enactment of a new law – namely that an entity has no liability to comply with a new law until that law has been substantively enacted, even though the entity would have to pay a third party to assume the uncertainty associated with a likely change in law.

55. The staff agrees that in many jurisdictions an entity expects to incur additional legal costs once legal proceedings have begun, even if the claim against the entity is entirely frivolous. But that staff thinks the entity is simply acting to protect its assets – that is to say, management are executing their fiduciary duty to shareholders. But management's duty to shareholders to protect the assets of the entity is not a present obligation, because it does not compel an entity to defend itself or incur additional legal costs.
56. Equally the staff does not think expecting to incur future legal costs to settle a lawsuit satisfies the definition of a liability. This is because an entity is not obligated to anybody for future legal costs at the balance sheet date (ie no counterparty with a right to the entity's asset exists). At the balance sheet date external legal counsel has no right to receive fees for future costs of defence. That right only exists when service has been performed. Also, the plaintiff is never entitled to the entity's own legal fees (even if the court ultimately orders the entity to pay damages for the underlying claim itself plus the plaintiff's legal costs). The staff thinks that its conclusion on legal costs is supported by the *Framework*¹³ which says that a distinction needs to be drawn between a present obligation and a future commitment. The ED also is consistent with this guidance – paragraphs 17 and 18 emphasise that a future action, or an intention to incur an outflow of economic resources, does not give rise to a present obligation¹⁴.
57. The staff acknowledges respondents' concerns that the measurement guidance included in the note accompanying Example 1 could be misleading. But the staff also notes that Example 1 also states that future legal costs should be taken into account when *measuring the unconditional obligation* at the balance

¹³ *Framework*, paragraph 61

¹⁴ Paragraph 17 and 18 of the ED are carried forward from paragraph 19 in the current IAS 37.

sheet date. Example 1 does not state that the expectation of incurring future legal costs creates a liability.

58. However, the staff is aware that one question remains unresolved – should legal costs be included in the measurement of a liability? The staff notes that this not a new issue created by the ED. Specific guidance on accounting for legal costs associated with the defence of ongoing litigation is not included in the current IAS 37. US GAAP also fails to provide definitive guidance¹⁵. But this is a measurement issue, not a recognition issue. Measurement issues are scheduled for discussion in the third quarter of this year. Therefore, whilst acknowledging that one question relating to legal costs remains unresolved, the staff will not address that question in this paper.
59. Based on the analysis above, the staff thinks that the start of legal proceedings does not resolve uncertainty about the facts relating to the claim against the entity. Secondly, the staff does not think that the start of legal proceedings in itself gives rise to a present obligation (even for expected future legal costs). Therefore the staff concludes that the start of legal proceedings is just one in a number of events that must be taken into account when determining whether a legal claim does give rise to a present obligation, but in isolation, the start of legal proceedings does not necessarily give rise to a liability. Therefore Example 1 requires revision.
60. **Does the Board agree?**

NEXT STEPS

61. In this paper the staff has revisited the two lawsuit examples included in the ED. We have concluded that Example 2 is correct because it identifies that the event giving rise to a present obligation is the violation of a contract, law or

¹⁵ The US EITF has already discussed topic D-77 *Accounting for Legal Costs Expected to be Incurred in Connection with a Loss Contingency*. PwC Accounting and Auditing Dataline 2004-29 reports that during the course of these discussions some parties argued that any accrual for a loss associated with litigation (established in accordance with SFAS 5 *Accounting for Contingencies*) should factor in all costs provided they are reasonable estimable, and that legal costs should be accrued regardless of whether the liability for the underlying claim itself can be reasonably estimated. Conversely, other parties argued that legal fees should be recognised as incurred and should not be recognised as part of any SFAS 5 accrual. But despite the disparity in view, the EITF declined to add the issue to its agenda. In relation to the same topic, the SEC stated that it would expect a registrant's accounting policy to be applied consistently and that APB Opinion No.22 *Disclosure of Accounting Policies* requires disclosure of material accounting policies and the methods of applying those policies. The staff is also aware that in practice the lack of guidance has created inconsistency in the treatment of legal costs amongst entities who prepare financial statements in accordance with US GAAP.

regulation. However, we have also concluded that the Example should be modified to clarify that the risk of such a violation being detected does not affect the conclusion that a liability exists (which, if it can be measured reliably should be recognised). Hence, in Example 2, an assessment of the likelihood of the deceased patient's relatives commencing legal proceedings is not relevant in determining whether a liability exists. The obligating event is the negligent act in the operation.

62. We have also concluded that Example 1 is inconsistent with Example 2 and incorrectly identifies the obligating event as being the start of legal proceedings. We do not think that the start of legal proceedings obligates the entity to stand ready. We think that conceptually whether there is a liability in Example 1 hinges on whether the entity sold harmful food and hence violated the law. The start of legal proceedings is just another piece of evidence that an entity evaluates in determining whether it has a liability—by itself, it does not obligate the entity.
63. The staff acknowledges that these conclusions raise challenging issues for developing guidance to assist entities in determining when they should recognise a liability in cases in which it is disputed whether a law or contract has been violated. In effect, these examples would be the most difficult examples of the issue of element uncertainty discussed last month. The conclusions also raise the possibility that entities could be involved in litigation and not recognise a liability (and not just because the liability could not be measured). For example, consider one Board member's example of the three suppliers, one of whom must have supplied a defective component to an entity, but it is impossible to determine which one. If the court were to award damages to the entity and split the cost amongst the three suppliers, for at least two of the suppliers, the obligating event would be the judgement of the court. This would be different to the current position in IFRS 3 *Business Combinations* in which all litigation in which an acquired entity is subject to a claim would be deemed to represent liabilities¹⁶.
64. The staff will therefore need to consider how we could articulate such guidance. We will also need to consider whether the difficulties of resolving element uncertainty in cases of dispute are so troublesome that one needs to

¹⁶ IFRS 3, paragraph 37

craft an exception to the recognition principle. For example, we could specify that an entity involved in litigation has a liability if, based on all the available evidence, it is more likely than not that the entity will be found liable.

65. We also note that our conclusions suggest that we will need to revisit the proposed disclosure requirements in the ED. For example, if an entity was subject to litigation but concluded that it did not have a liability, we think that the existence of the litigation is decision-useful information. However, it would not have required disclosure under the ED and we are not sure that it would be captured by the 'key sources of estimation uncertainty' requirements in IAS 1 *Presentation of Financial Statements* (paragraph 116 onwards).
66. However, before we continue working on this issue, we would like Board member views on our revised conclusions on Examples 1 and 2 of the ED.

APPENDIX A: EXAMPLES 1 & 2 FROM THE ILLUSTRATIVE EXAMPLES ACCOMPANYING THE ED

Example 1: Disputed lawsuit

After a wedding in 20X0, ten people died, possibly as a result of food poisoning from products sold by the entity. Legal proceedings have been started seeking damages from the entity. However, the entity disputes liability because it does not believe that its food was harmful. Up to the date of authorisation for issue of the financial statements for the year to 31 December 20X0, the entity's lawyers advise that it is unlikely that the entity will be found liable.

Present obligation as a result of a past event – The past event is the start of legal proceedings. Up to this point, the entity was not aware that it had sold harmful food. Even at the time the entity authorises for issue its financial statements, it disputes that it sold harmful food. Nonetheless, the start of legal proceedings obliges the entity to stand ready to perform as the court directs and hence the entity has a present obligation.

Conclusion – A non-financial liability is recognised.

A note about measurement – The objective in measuring the liability is to estimate the amount that the entity would rationally pay to settle or to transfer the obligation *on* the balance sheet date. Even if the entity expects that it will not be found liable, no other party would assume the obligation on the balance sheet date without being compensated by the entity. This is because of the costs involved in defending the lawsuit and the risk of an adverse outcome.

In measuring the liability at 31 December 20X0, the entity considers factors such as:

- the possible outcomes of the lawsuit;
- the cash flows associated with those outcomes (including the costs associated with the lawsuit);
- the timing of the cash flows;
- the probabilities of those outcomes; and
- the risks and uncertainties associated with the obligation (ie the range or variability of the possible outcomes).

The last factor is sometimes referred to as a 'risk adjustment' and it is the amount that a third party would demand for bearing the uncertainty and unforeseeable circumstances inherent in the obligation concerning the amount and timing of any cash flows.

Example 17 gives guidance on the use of an expected cash flow approach, in which multiple cash flow scenarios are weighted by their respective probabilities, as the basis for measuring a liability.

Example 2: Potential lawsuit

Shortly before 31 December 20X0, a patient dies in a hospital as a result of a mistake made during an operation. The hospital is aware that a mistake occurred. In these circumstances, the hospital's past experience and lawyers' advice indicate that it is

highly likely that the patient's relatives will start legal proceedings and, if the matter comes to court, that the hospital will be found guilty of negligence.

At the time that the financial statements are authorised for issue in early 20X1, the hospital has not received notice of legal proceedings against it.

Present obligation as a result of a past event – The past event is the operation in which negligence occurred.

Conclusion – A non-financial liability is recognised.

A note about measurement – Measurement of the liability reflects the likelihood that the hospital will be required to pay compensation because of the mistake, and the amount and timing of that compensation.