Project **Liabilities—IFRS to replace IAS 37**

Topic

Recognition criteria—threshold for 'liability exists' criterion

Overview of paper

1 This paper considers whether the IFRS should specify a more-likely-than-not threshold for the judgement about whether a liability exists (recognition criterion 1). IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* applies this threshold at present. The Board has previously tentatively decided to omit it from the IFRS to replace IAS 37.

2 The staff recommend that the Board reverses its previous tentative decision, ie that it keeps the existing IAS 37 more-likely-than-not threshold in the IFRS.

Background

3 At present IAS 37 states that:

> 15 **In rare cases, it is not clear whether there is a present obligation. In these cases, a past event is deemed to give rise to a present obligation if, taking account of all available evidence, *it is more likely than not that* a present obligation exists at the end of the reporting period.**
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> 16 …In rare cases, for example in a law suit, it may be disputed either whether certain events have occurred or whether those

> events result in a present obligation. In such a case, an entity determines whether a present obligation exists at the end of the reporting period by taking account of all available evidence, including, for example, the opinion of experts. The evidence considered includes any additional evidence provided by events after the reporting period. On the basis of such evidence:
>
> (a) where *it is more likely than not that* a present obligation exists at the end of the reporting period, the entity recognises a provision (if the recognition criteria are met); and
>
> (b) where *it is more likely that* no present obligation exists at the end of the reporting period, the entity discloses a contingent liability… (Emphasis added.)

4 As part of its review of the recognition requirements in IAS 37, the IASB tentatively decided to omit the more-likely-than-not threshold from the IFRS. Its reasons were that:

(a) other IFRSs require entities to make judgements in situations of uncertainty without specifying thresholds. For example IAS 27 *Consolidated and Separate Financial Statements* and SIC-12 *Consolidation—Special Purpose Entities* require the management of an entity to judge whether that entity controls other entities. SIC-12 states that: 'The application of the control concept requires, in each case, judgement in the context of all relevant factors'. The threshold in IAS 37 is an unnecessary 'bright line', which leads to similar situations being treated differently.

(b) as an alternative to a 'bright line' threshold, the IFRS should provide additional guidance on the evidence that management would consider when reaching its judgement about whether a liability exists.

5 Accordingly, the resulting text in the working draft IFRS was:

Uncertainty about existence of present obligation

13 In some situations, for example if governmental, legal or arbitration proceedings are in progress, pending or threatened against the entity, there might be uncertainty about whether the entity has an obligation. It might be uncertain:

(a) whether the events that would give rise to an obligation occurred; or

(b) how the law applies to those events.

14 In such situations, the management of the entity shall judge whether an obligation exists, taking into account all available evidence and giving more weight to the evidence that is more persuasive. The nature and extent of the available evidence will depend on the circumstances. It could include:

(a) the entity's own experience with similar items;

(b) other entities' experience with similar items;

(c) information provided by a claimant;

(d) reports from those investigating the claim;

(e) opinions of experts; and

(f) additional evidence provided by events after the reporting period, to the extent that the evidence relates to conditions that existed at the end of the reporting period.

This list is not exhaustive. If other sources of evidence exist, management shall also consider the evidence from those other sources.

Comments from respondents to working draft IFRS

6 Some of those who commented on the working draft IFRS specifically referred to the Board's intention to remove the more-likely-than-not threshold from the requirement to judge whether a liability exists. These respondents—including the Law and Accounting Committee of the American Bar association and a number of US preparers—opposed the removal, arguing that:

(a) without the threshold, the existence test is unworkable. By their very nature, lawsuits tend to involve situations in which the available evidence is open to different interpretations. The existence test cannot be applied without specifying a probability threshold.

(b) without a prescribed threshold, preparers and auditors will have to develop their own policies. These might vary between entities, reducing comparability and requiring costly debates between individual preparers and auditors.

(c) without a reference to probability, a judgement that a defendant does not have a liability could be viewed as 'wrong' if the courts later rule against the defendant. Entities defending lawsuits could therefore be vulnerable to claims of accounting errors from their investors.

(d) the Board has accepted the need for a more-likely-than-not threshold elsewhere—eg in the proposed definition of a lease term[1]—and has not made any real case for removing the threshold from IAS 37.

7 The comments of some other respondents—again including several US preparers—indicate that the inclusion of the more-likely-than-not threshold for judgments about existence (criterion 1) might lessen their concerns (explained in Paper 8C) about the Board's tentative decision to remove entirely the 'probable outflows' recognition criterion (criterion 2). In other words, those respondents' concern appears to be less about the change in focus from outflows to existence, and more about a wish to retain an explicit probability threshold *somewhere* in the recognition decision process.

[1] Appendix A of exposure draft *Leases* proposes to define a lease term as 'the longest possible term that is more likely than not to occur'.

Further staff comments

8 The staff further note that there is a difference between the judgement about whether a defendant in a lawsuit has a present obligation and other judgements required by IFRSs, such as judgements about control:

(a) if there is uncertainty about whether one entity controls another, that uncertainty arises because some, but not all, of the indicators of control are present—the evidence is contradictory. Management's job is to weigh the evidence on both sides and reach an overall judgement. Management can reach a judgement because the relevant facts, and their implications, are known. There is no need for a future event to resolve uncertainty.

(b) in contrast, the uncertainty about whether a defendant in a lawsuit has a liability arises because the facts, or their consequences, are disputed. The uncertainty will ultimately be resolved by a future event (eg a final court ruling) that confirms whether a liability exists (a 'confirming event'). A judgement about whether a liability exists requires management to do more than weigh the evidence already available. Management must also make predictions about the outcome of the future confirming event.

It could be argued that the need for a probability threshold arises from the need to predict the outcome of the future confirming event without having perfect information about all the factors that will affect that outcome.

9 It is also of note that a more-likely-than-not threshold could help to address other concerns expressed about the proposed recognition criteria. If management concludes that the probability of a liability existing is less than 50 per cent, it need not attempt to pinpoint the probability more precisely. This would avoid the need for some difficult judgements and reduce the risk of self-incrimination through the discovery process.

10 If the Board were to prescribe a probability threshold in the judgement about whether a liability exists, it need not prescribe the same threshold as IAS 37 does. The Board could prescribe a lower or a higher threshold. However, the staff think that the more-likely-than-not threshold in IAS 37 is well-accepted and we have not identified persuasive arguments for raising or lowering it. Therefore, we have not investigated alternatives.

Staff conclusions and recommendations

11 In the light of the arguments above, the staff conclude that the advantages of keeping the more-likely-than-not threshold in the judgement about whether a liability exists outweigh the disadvantages. In particular, the Board could justify including the threshold in the IFRS that replaces IAS 37 on the grounds that:

(a) without an explicit threshold, practices could diverge or develop in ways not intended by the Board;

(b) including a threshold should help to address respondents' concerns that the proposed recognition criteria would be more difficult to apply than the existing IAS 37 criteria; and

(c) the need to predict uncertain future events in the absence of perfect information differentiates the judgement required in IAS 37 from the recognition judgements in some other IFRSs.

Question for the Board
The staff recommend that the IFRS, like IAS 37, should specify a more-likely-than-not threshold for the judgement about whether a liability exists (recognition criterion 1). Do you agree?