

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

Topic **Draft text—guidance for ‘liability exists’ criterion**

Purpose of appendix

In paper 8B, the staff recommend adding more guidance on applying the requirement to judge whether a liability exists.

This appendix proposes draft text to implement the staff recommendations.

The wording of parts of the guidance will depend on whether the Board decides to include the ‘more-likely-than-not’ threshold proposed in Paper 8A. In this appendix, the threshold is included in square brackets.

This paper has been prepared by the technical staff of the IFRS Foundation for discussion at a public meeting of the IASB. The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

Suggested amendments to guidance within body of working draft IFRS

The text shown as deleted below is not deleted entirely. Instead, it is moved from the body of the IFRS to an appendix of application guidance (see next section).

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.

The uncertainty will be resolved only on the occurrence of a future event, such as a final court ruling, that confirms whether the entity has an obligation.

- 14 In such situations, the management of the entity shall judge whether [it is more likely than not that] 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;~~

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~~(e) — opinions of experts; and~~

~~(f) — The evidence considered includes any 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.~~

~~15 — The start of proceedings against an entity is not in itself an event that gives rise to an obligation. However, it might provide evidence that is relevant to the assessment of whether such an event has occurred.~~

16 If the management of the entity concludes from the available evidence that [it is more likely than not that] the entity has an obligation, and the other recognition criteria in paragraph 7 are met, the entity recognises a liability. If the management concludes from the available evidence that [it is more likely than not that] the entity does not have an obligation, the entity does not recognise a liability. Instead, it discloses the information required by paragraph 51 of this [draft] IFRS.

Suggested additional guidance for appendix C of working draft IFRS

This draft guidance incorporates the text moved from the body of the IFRS. The rest is additional guidance.

Liabilities arising from existing or potential future legal proceedings

C20 If, before the end of the reporting period, an entity has committed an act of wrongdoing for which the law imposes fines or requirements to pay compensation to injured parties, the entity has a present obligation for unpaid fines or compensation. The entity's obligation exists irrespective of whether legal proceedings have yet commenced against the entity: the obligation arises from the act of wrongdoing, not from the detection of the act by another party or from the commencement of legal proceedings. Events that indicate that the entity may have committed such an act include, for example:

- (a) the commencement of legal proceedings against the entity;
- (b) a threat of a governmental or regulatory investigation into the entity's activities; or
- (c) the occurrence of a catastrophe or an accident that might lead to a claim for redress against the entity.

C21 The commencement of legal or similar proceedings against the entity is not in itself proof that the entity has a present obligation. The entity might dispute that it has an obligation if, for example, there is uncertainty about whether alleged events occurred or whether alleged harm is attributable to these events. The uncertainty will be resolved only on the occurrence of a future event, such as a final court ruling, that confirms whether or not the entity has an obligation.

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C22 In such situations, management considers the available evidence and reaches a judgement about whether [it is more likely than not that] the entity has a present obligation. [It is more likely than not that] / [Management would judge that] an entity defending legal proceedings has a present obligation if the available evidence indicates that either:

- (a) if the case proceeds to court, [it is more likely than not that] the courts will rule against the entity; or
- (b) [it is more likely than not that] the entity will offer an out-of-court settlement instead of defending the case.

C23 In reaching its judgement, management might rely on advice and opinions from internal and/or external legal counsel. Management and legal counsel consider all available evidence and give more weight to evidence that is more persuasive. The available evidence might include:

- (a) reports of events from those investigating the claim
- (b) expert opinions
- (c) information received from claimants
- (d) legal precedents set in similar cases.

This list is not exhaustive. If other sources of evidence exist, management and its legal counsel also consider the evidence from those other sources.

C24 During the early stages of legal proceedings, the entity might lack specific and detailed evidence on which to judge whether it has an obligation. Management might rely primarily on more general information, such as the entity's—or other entities'—experience with similar cases. As the case progresses and more specific evidence becomes available, management's judgement might change. The entity recognises a liability when management first judges that [it is more likely than not that] a liability exists and can be measured reliably. The entity derecognises the liability if later evidence causes management to reverse this judgement.

Draft illustrative examples

The working draft IFRS does not yet include any illustrative examples. The staff recommend adding the following example, which uses the same facts as the Example 10 in IAS 37

Provisions, Contingent Liabilities and Contingent Assets and arrives at the same conclusions.

Example 1: Disputed legal proceedings

IE1 After a wedding in 20X0, ten people died, possibly as a result of poisoning from food supplied by the entity. Legal proceedings are started seeking damages from the entity. However, the entity disputes liability because it does not believe that the food it supplied was harmful.

IE2 The event giving rise to an obligation to pay damages is the supply of harmful food. If the entity supplied food that harmed the wedding guests, it has present obligation. Because is uncertain whether the entity supplied harmful food, it is uncertain whether the entity has a present obligation.

Financial statements for reporting period ended 31 December 20X0

IE3 The entity's lawyers consider all evidence available to the entity up to the date of authorisation of the 20X0 financial statements. On the basis of this evidence, they advise that it is likely that the claim against the entity will fail—the courts will not find the entity liable. On the basis of this advice, management judges that [it is more likely than not that] the entity does not have a present obligation.

IE4 The entity does not recognise a liability. However, it discloses information about the legal proceedings as required by paragraph 51 of the [draft] IFRS.

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Financial statements for reporting period ended 31 December 20X1

IE5 During 20X1, further evidence becomes available. In the light of the new evidence, the lawyers now advise that it is likely that the claim against the entity will succeed—the courts will find the entity liable.

IE6 On the basis of this advice, management judges that [it is more likely than not that] the entity has a present obligation. Using opinions from the lawyers about the various amounts that might be payable in damages if the claim succeeds, management is able to determine an estimate of the obligation that is sufficiently reliable to meet the recognition criteria.

IE7 The entity recognises a liability.¹

Example 2—Claim for patent infringement

If the Board decides to include an expectation of a future out-of-court settlement as a trigger for identifying a liability (ie paragraph C22(b) of draft guidance above), it could also add an example to illustrate this requirement. The example drafted below also reminds readers that information is disclosed by class, but that claims need to be similar in nature to be disclosed as a single class.

¹ We could also use this example to illustrate the measurement requirements. The staff suggest revisiting this possibility after the Board has reconsidered the measurement proposals. The examples in IAS 37 at present address only recognition.

Example 2: Claim for patent infringement

IE8 Various third parties have separately accused the entity of infringing their patent rights and have made claims for compensation against the entity.

IE9 The entity has sought preliminary advice from experts. This advice indicates that, although the entity may be able to defend the claims successfully, the arguments in some cases are not clear cut. The entity would need to obtain further specialist opinions and the costs of defending these cases would be high. In similar situations in the past, the entity has settled with claimants instead of defending the claims.

IE10 On the basis of this evidence, management judges that [it is more likely than not that] it will settle some of the claims rather than defend them. Using its experience with similar claims, management is able to determine an estimate of the possible settlement amounts for these claims that is sufficiently reliable to meet the recognition criteria. Consequently, the entity recognises liabilities for the claims.

IE11 The claims are sufficiently similar in nature that aggregated information about them is sufficient to fulfil the disclosure requirements of the [draft] IFRS. Consequently, the entity treats the recognised liabilities as a single class for disclosure purposes.