

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

Topic **Recognition—guidance for ‘liability exists’ criterion**

Purpose of this paper

- 1 The working draft IFRS includes some guidance on how entities should apply the recognition criteria if there is uncertainty as to whether a liability exists. Respondents asked for more guidance. The paper discusses respondents’ suggestions and recommends adding substantially more guidance and illustrative examples. Drafting suggestions are added in the appendix to this paper.

Background

- 2 While conducting outreach activities during the comment period for the exposure draft, staff and Board members became aware that constituents were struggling to understand how the proposed changes to the recognition requirements would affect the recognition of liabilities by entities defending legal proceedings. In particular, some constituents thought that the removal of the ‘probable outflows’ recognition criterion (criterion 2 in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*) would require entities to recognise liabilities whatever the likely outcome.

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.

- 3 In response, the staff posted to the IASB website in April 2010 a [staff paper](#) [Recognising Liabilities arising from Lawsuits](#)¹. The main conclusions in the staff paper were that:
- (a) removing the ‘probable outflows’ recognition criterion would *not* require defendants to recognise liabilities for all lawsuits—management would need to consider the available evidence and reach a judgement about whether a liability exists. They would need to consider the validity of the plaintiff’s case against the entity.
 - (b) removing the ‘probable outflows’ criterion would not necessarily require defendants to recognise more liabilities than they recognise when applying IAS 37 at present. In most cases, if the entity’s management thinks that no outflows are probable, it does so because the available evidence suggests that the court will rule in the entity’s favour. Such evidence would also support a judgement that no liability exists.

Respondents’ comments

- 4 Thirty respondents—mainly preparers, but also including the International Auditing and Assurance Standards Board and several accounting standard-setters—asked for more guidance in the IFRS on applying the recognition requirements to situations (such as legal proceedings) in which it is uncertain whether an obligation exists. Some pointed out that when the Board last discussed this matter back in 2007, it had some difficulty in reaching its conclusions, and that the only available guidance is in the non-authoritative staff paper—which might not necessarily be supported by the Board.

¹ Accessed from ‘Related Information’ links on the Liabilities project page: <http://go.iasb.org/liabilities>

5 Respondents made seven specific suggestions, each of which is discussed further in the next section of this paper:

- explicitly link recognition of a liability to the likely court ruling (see paragraphs 7-9)
- emphasise the role of precedents (see paragraphs 10-12)
- clarify how exhaustive the search for ‘available evidence’ need be (see paragraphs 13-15)
- include the conclusions of the staff paper (see paragraphs 16-24)
- reconsider one of the conclusions in the staff paper, namely the conclusion that an expectation of an out-of-court settlement is *not* of itself grounds for recognising a liability (see paragraphs 25-31)
- reconsider some of the terminology used in the staff paper (see paragraphs 32-33)
- explain how entities should apply the requirements during the early stages of the proceedings (see paragraphs 34-37).

Staff analysis and recommendations

6 In this section, the staff analyse each of the suggestions above and recommend whether and how the suggested guidance should be included. The recommendations are somewhat intertwined, so the staff do not ask the Board to approve each one individually. Rather, at the end of this paper, the staff ask the Board for comments on a preliminary draft of guidance that implements the staff recommendations.

Link judgement with likely outcome of case

- 7 Some respondents suggested that the IFRS should state more explicitly that an entity defending legal proceedings should consider the likely ruling of the court when judging whether it has a present obligation.
- 8 The staff think that a clear statement to this effect would address much of the confusion that has arisen about the recognition requirements:
- (a) the Board has concluded that legal proceedings are among the situations in which it might be uncertain whether a liability exists. In such situations, the existence of a liability at the reporting date will be confirmed only by the occurrence of a future event, such as a final court ruling. If a future event will confirm the existence of a liability, it seems logical that judgements about whether the liability exists should focus on the likely outcome of that event (the ‘future confirming event’). In other words, the appropriate test for judging the existence of a lawsuit would be:

[Does the available evidence indicate that the courts will rule against the entity?](#)
 - (b) specifying the exact nature of the judgement that entities need to make would fill in a gap in the draft IFRS. The existing working draft specifies *how* entities should go about judging existence (by giving examples of the evidence they should consider) but it does not specify *what* they should be seeking to judge.
- 9 The staff recommend:
- (a) introducing the idea of a future confirming event into the discussion of uncertainty about existence; and
 - (b) adding a section of application guidance for legal proceedings and including in that application guidance a test that requires management to use the available evidence to reach a judgement about how the courts will rule.

Emphasis role of precedents

- 10 One respondent suggested that guidance should emphasise that the likelihood of the entity's position prevailing in court is assessed taking account of the views of internal and external legal counsel and, if available, legal precedents set by similar cases. In that respondent's opinion, relevant precedents are likely to be the best available means of determining the current views of the courts.
- 11 The staff think that such guidance would be a helpful addition to the IFRS. It would be consistent with the test that entities need to apply to judge whether a liability exists (will the courts rule against the entity?) and would emphasise that the test needs to be applied on the basis of available evidence (relevant precedents can provide objective and persuasive evidence).
- 12 Accordingly, the staff have included references to internal and external legal counsel and relevant precedents in the draft guidance.

Clarify how exhaustive the search for evidence need be

- 13 Two respondents asked the Board to specify how exhaustive the entity's search for available evidence has to be. In their view, a requirement to consider *all* available evidence would be unduly onerous for entities to implement and auditors to verify. The respondents suggested that the IFRS could:

- (a) require entities to consider *reasonably* available evidence;

- (b) use caveats similar to those in the proposed IFRS on fair value measurement (entities need not undertake exhaustive searches but should not ignore information that is reasonably available); or
 - (c) apply a cost-benefit constraint similar to that applied in IAS 36 *Impairment of Assets*².
- 14 It could be argued that such caveats are not necessary in the IFRS that replaces IAS 37:
- (a) there are no such caveats in IAS 37 at present. IAS 37 requires entities to judge whether a liability exists taking into account ‘all available evidence’; and
 - (b) unlike, say, the IFRS on fair value measurement, the IFRS that replaces IAS 37 would not require entities to gather information (eg from a potentially infinite pool of market data) purely for accounting purposes. Entities defending legal proceedings need to gather all relevant evidence about possible outcomes to make decisions about whether and how to proceed with the case. Management would also use this existing pool of evidence to support accounting judgements.
- 15 Accordingly, the staff suggest that there is no need to limit the evidence to which entities should refer when judging whether a liability exists. The draft guidance continues to refer to ‘all available evidence’.

² Paragraph A12 of IAS 36 discusses the amount of information that entities need to build into expected value measurements. It states that: ‘The entity needs to balance the cost of obtaining additional information against the additional reliability that information will bring to the measurement’.

Include conclusions from staff paper

- 16 Many respondents asked the Board to debate the conclusions in the staff paper and, to the extent that the Board agrees with the conclusions, incorporate them as application guidance in the IFRS.

Main conclusion in staff paper

- 17 The main conclusion in the staff paper was that, for most legal proceedings, the change in the recognition criteria would have little effect on the recognition decision: the factor that underpins the likelihood of future outflows (the final court ruling) is also the factor that underpins the judgement about whether a liability exists.
- 18 If the Board agrees with this conclusion, it could incorporate guidance to this effect by:
- (a) specifying a need to judge how the courts will rule (as discussed above); and
 - (b) adding an illustrative example that uses the same facts as an existing illustrative example in IAS 37—ie Example 10 *A court case*—and comes to the same conclusions about whether a liability should be recognised.
- 19 The staff have added such an example to the draft guidance.

Other conclusions in staff paper

- 20 The staff acknowledged in the staff paper that the proposed changes in the recognition criteria would require entities to recognise *some* liabilities that they do not recognise when applying IAS 37.

- 21 Such liabilities arise when an entity has committed an act of wrongdoing but expects to avoid any future outflows:
- Applying IAS 37, the entity *would not* recognise a liability because the liability would fail the ‘probable outflows’ recognition criterion.
 - Applying the draft IFRS, an entity *would* recognise a liability (if it were material and could be measured reliably). The entity would take the improbability of outflows into account in the measurement of the liability.
- 22 Such situations would include those in which management has detected an act of wrongdoing but does not expect a third party to assert a claim against the entity. If the Board wished to address such situations in the draft guidance, it could:
- (a) clarify that the obligation arises from the act of wrongdoing, not the detection of the act by another party or the assertion of a claim against the entity; and/or
 - (b) include an example illustrating that an entity might need to recognise a liability even if its actions have not yet resulted, or indeed might never result, in legal proceedings.
- 23 The staff recommend that the draft guidance should clarify that obligations arise from acts of wrongdoing, not from detection of the act by a third party or the assertion of a claim against the entity. Accordingly, we have included a statement to this effect in the draft guidance.
- 24 However, the staff do not recommend adding an illustrative example. The expected values of unasserted claims are often immaterial (especially because the probability of future outflows is often low). It could be argued that material liabilities for unasserted claims will be the exception rather than the rule. Including an example might imply otherwise. Accordingly, we have not included an example in the appendix.

Reconsider conclusion about out-of-court settlements

- 25 Respondents challenged one of the conclusions in the staff paper. They challenged the conclusion relating to situations in which management does not accept that the entity is liable, but nevertheless expects to offer the claimant an out-of-court settlement as a lower-cost and lower-risk alternative to defending a claim through the courts. The staff paper concluded that in such situations, the entity should *not* recognise a liability: the entity has neither an obligation arising from an act of wrongdoing nor (yet) an unconditional obligation to pay the out-of-court settlement.
- 26 A few respondents explicitly agreed with this conclusion and asked the Board to clarify the point to eliminate existing diversity in practice. However, other respondents disagreed. Some thought that the staff had interpreted the requirements wrongly. Others were more concerned that, by not recognising a liability until the settlement offer became binding, entities would deprive users of potentially useful information about the future consequences of past events.
- 27 Participants in outreach meetings have made similar comments, and these have caused the staff to reconsider our earlier conclusion.
- 28 Participants in outreach meetings often provided examples involving patent infringement and similar claims. They noted that the defence of patent infringement claims relies on complex technical opinions and defence costs tend to be high relative to the amounts of compensation payable. Consequently, the vast majority of patent infringement claims (99 per cent of those in the US, according to Wikipedia) are settled before reaching court.
- 29 It could be argued that, in such cases, it is not practical to require management to investigate in minute detail the likely outcome if the case were to reach court. As a practical short cut, they should be allowed to consider whether the available evidence suggests that the claim will result in a settlement to the patent holder.

- 30 If this approach were to be taken in the IFRS, the staff think that it would also be important to make a clear statement in the basis for conclusions about the reasons:
- (a) an expectation of a future outflows is *not* of itself sufficient grounds for identifying a liability. A liability requires a present obligation; but
 - (b) in these especially difficult situations of uncertainty, identifying claims that are likely to result in out-of-court settlements is a practical short cut that avoids excessively detailed investigation of the merits of claims that are unlikely to reach court.
- 31 The staff think that this approach could solve some of the practical difficulties of applying the proposed recognition criteria and would provide decision-useful information to investors. Accordingly, the draft guidance proposes that an entity would judge that a liability exists if the available evidence suggests that *either*:
- (a) if the case proceeds to court, the courts will rule against the entity; or
 - (b) the entity will offer an out-of-court settlement instead of defending the case.

Reconsider terminology used in staff paper

- 32 A few respondents asked the Board to reconsider some of the terminology used in the staff paper. The paper used terms such as ‘without merit’, ‘no merit’, ‘lacks merit’, ‘valid claim’, and ‘when resolved’, which can be interpreted in different ways. (‘Without merit’ in particular is used in US standards to mean ‘remote’, which is not the sense in which it was used in the staff paper.)
- 33 The staff have avoided such terminology in the additional guidance in the appendix. It is easy to avoid this terminology if we link the existence of a liability to a future court ruling. Instead of having to refer to the available evidence suggesting that ‘the other party has a valid claim’ against the entity, we can refer to the available evidence suggesting that the ‘court will rule against the entity’.

Explain how requirements apply at early stages of lawsuits

- 34 A few respondents asked for more guidance for entities in the early stages of lawsuits, when there may be less evidence on which to base a judgement about whether a liability exists. One respondent suggested that if there is insufficient information on which to base a judgement, the entity should not recognise a liability.
- 35 An alternative view might be that a prediction of the outcome is possible at *any* stage in the proceedings. The judgement should depend upon the *balance*, not the *quantity*, of the available evidence. In the early stages, management might rely on more general evidence, such as past experience of similar claims. As more specific evidence becomes available, management uses that evidence to refine its earlier judgements.
- 36 The staff favour this alternative view. In the staff's view, delaying recognition until there is sufficient evidence to support a particular level of confidence in the judgement would implicitly raise the recognition threshold and could delay recognition of liabilities until very late in the proceedings.
- 37 Accordingly, the staff have drafted guidance that explains how management might assess the evidence early on in the case, and how its judgements might change as more evidence becomes available.

Possible next steps

- 38 The appendix illustrates how the Board might draft additional guidance for the IFRS to take into account the suggestions of respondents and the staff recommendations above. Subject to the views of the Board, the next step could be to engage informally with interested parties to seek their views on whether this draft guidance would be helpful to them. The staff could, for example, place the draft guidance on the website and specifically bring it to the attention of respondents who might have an interest in commenting informally on it.

Questions for the Board

Question 1: out-of-court settlements

For the reasons set out in paragraphs 8 and 25-31, the staff propose that guidance should specify that an entity defending a lawsuit should judge that a liability exists if the available evidence indicates that either:

- (a) if the court proceeds to court, the courts will rule against the entity;
or
- (b) the entity will offer an out-of-court settlement instead of defending the case.

Do you agree that these are appropriate criteria for identifying liabilities arising from lawsuits?

Question 2: early stages of lawsuits

For the reasons set out in paragraphs 35 and 36, the staff recommend that the IFRS should require management to judge whether a liability exists even in the early stages of legal proceedings, when specific evidence might be limited. In other words, entities should not delay recognition of a liability until there is sufficient evidence to support a particular level of confidence in the judgement.

Do you agree with this recommendation?

Question 3: other comments

Do you have any other comments on the draft guidance in the appendix?

Question 4: consultation

Would you like the staff to engage with interested parties to seek informal comments on the draft guidance (as amended for decisions taken in this meeting)?