IASB Meeting | Agenda reference **8C**

Staff Paper | Date **16 November 2010**

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

Topic **Recognition—removal of 'probable outflows' criterion**

Overview of paper

1 At present, IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* requires an entity to recognise a liability only if 'it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation' (recognition criterion 2). Early in this project, the Board tentatively decided to remove this 'probable outflows' criterion from the IFRS that replaces IAS 37. The Board exposed this tentative decision in the 2005 exposure draft and reaffirmed the decision when it redeliberated the proposals during 2006 and 2007.

2 Some constituents remain opposed to the removal of the probable outflows criterion and expressed their continuing opposition when commenting on the 2010 exposure draft of the revised measurement proposals. This paper considers their arguments. It starts by explaining the reasons for the Board's tentative decision to remove the criterion.

Reasons for proposing to remove the probable outflows criterion

3 The probable outflows criterion in IAS 37 derives from the IASB *Framework,* which states that.

> 91 A liability is recognised in the balance sheet when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation…

4 Although the criterion is in the *Framework*, it has not been included in other IFRSs to which it might apply. For example, IAS 39 *Financial Instruments: Recognition and Measurement* does not apply a probable outflows criterion for the recognition of financial guarantees or written options. IAS 39 requires entities to recognise all guarantees or written options as liabilities, taking the possible outcomes into account in the measurement of the liabilities.

5 As a result of the probable outflows criterion, some liabilities within the scope of IAS 37 remain 'off balance sheet' even though they can be measured reliably. Although liabilities that fail the probable outflows criterion must be disclosed, they need not be measured. Investors are therefore deprived of information that could be useful to them for investment decisions.

6 The probable outflows criterion also sits uncomfortably with the proposed 'expected value' measurement model, which takes into account all possible outcomes weighted by their associated probabilities. If financial statements distinguish liabilities with differing probabilities of future outflows by measuring them at different values, there seems to be no conceptual need for an arbitrary probability threshold below which a material liability and expense are not recognised at all.

7 If an entity does not recognise liabilities acquired in a business combination, it undervalues the acquired goodwill, or even wrongly recognises negative goodwill. The Board's amendments to IFRS 3 *Business Combinations* in 2008 overcame this problem by applying an exception for liabilities that are within the scope of IAS 37. Entities are required to recognise IAS 37-type liabilities acquired in a business combination without applying the probable outflows criterion. The exception applies at the time of acquisition and for as long as the liability continues to exist thereafter. Thus, the recognition requirements for liabilities within the scope of IAS 37 are different, depending on whether the entity originally acquired the liability in a business combination or through its own activities.

8 IAS 37 does not apply the probable outflows criterion strictly, ie to each liability individually. Instead, it requires entities to apply the criterion to groups of similar liabilities as a single unit of account. If it is probable that even some of the liabilities within a class will result in an outflow, entities are required to recognise all the liabilities within that class. Consequently, if an entity has issued guarantees within the scope of IAS 37, the probable outflows criterion prohibits recognition of the guarantees only if it is probable that *none* of them will be called upon.

9 Thus, there are several reasons for removing the probable outflows criterion from the IFRS that replaces IAS 37:

(a) removing the criterion would reduce 'off balance sheet' obligations, and the resulting loss of information that could be relevant for investment decisions;

(b) removing the criterion would create a simpler and more cohesive accounting model for liabilities within the scope of IAS 37. For liabilities such as guarantees, the recognition criteria would have the same effect whether applied to individual liabilities or to whole classes of liability as a single unit of account. In addition, all expectations about the probability of future outflows would be factored into the measurement of those liabilities.

(c) removing the criterion would eliminate inconsistencies between IAS 37 and other IFRSs. For example, the recognition criteria for a guarantee obligation would be the same whether the guarantee is within the scope of IAS 39 or of IAS 37, and regardless of whether the entity originally assumed the guarantee as part of a business combination or through its own activities.

(d) removing the criterion would eliminate the need for one of the exceptions in IFRS 3, thus simplifying the application of that standard.

10 Another point of note is that removing the probable outflows criterion may have relatively little impact on the number of liabilities recognised by many entities. Liabilities that fail the probable outflows test in IAS 37 are often those that might exist for entities defending legal proceedings. If management predicts that there will probably be no future outflows, it often does so because the available evidence indicates that the courts will rule in favour of the entity, ie that no liability exists. In other words, possible liabilities arising from legal proceedings often either satisfy *both* the probable outflows and ‘probably exists’ recognition criteria or *neither* of them—the recognition decision would be the same whether the probable outflows criterion is present or not.

Comments from respondents to exposure draft of revised measurement proposals

11 The Board did not specifically invite comments on the working draft IFRS that it posted to its website to accompany the exposure draft of the revised measurement proposals. Nevertheless, approximately one third of respondents to the exposure draft commented on the Board’s intention to remove the probable outflows recognition criterion.

Supporters

12 A small number of respondents (including preparers, a regulator and a national standard-setter) expressed explicit support for, or at least acceptance of, the change. They argued that:

(a) removing the probable outflows criterion would ensure that entities recognised and measured all liabilities that they could measure reliably. The existence and magnitude of liabilities become more apparent if they are 'on balance sheet';

(b) at present, people fail to distinguish existence uncertainty from measurement uncertainty. Changing the recognition criteria might help to address this confusion.

Opponents

13 In contrast, approximately seventy respondents expressed opposition to the removal of the probable outflows criterion. This group included almost all the European national accounting standard-setters, most of the accounting firms and a significant number of preparers. The main reasons that they gave were that:

(a) recognition of liabilities that will probably *not* result in an outflow of benefits:

(i) does not provide relevant information to investors; and

(ii) imposes unjustified burdens on preparers.

(b) the probable outflows criterion is a useful practical filter that avoids the need for complicated judgements about whether a liability exists.

(c) recognition of liabilities for unasserted claims would increase the risk of a claim being asserted.

(d) IFRSs should be consistent with the *Framework*. The Board should not change individual IFRSs without first undertaking the due process procedures required to update the *Framework*.

(e) IAS 37 does not need to be consistent with other IFRSs.

Staff analysis

14 This section considers each of the above arguments in more detail.

Relevant information for investors

15 Many of the respondents who opposed the removal of the probable outflows criterion argued that, in combination with the proposed changes to the measurement requirements, removal of the criterion would cause financial statements to provide information that is less relevant for investors. Entities would recognise some liabilities (such as one-off guarantees and undetected acts of wrong-doing) even if the chances of a future outflow were less than 50 per cent. In the view of these respondents, disclosure of a possible outflow is more useful than recognition of an unlikely outflow.

16 In response, it could be argued that:

(a) the recognition of a liability would be in addition to, not instead of, the disclosure of a possible future outflow.

(b) if, despite the low probability of outflows, the expected value of a liability is material, that liability materially reduces the value of an investor's claim on the entity's assets. Financial statements that fail to quantify the effect of such liabilities, or to quantify the effect of changes in expectations about the outcomes, deprive investors of information that could be relevant for making decisions.

(c) none of the six user groups responding to the exposure draft raised any objections to the Board's intention to remove the probable outflows recognition criterion.

Onerous burdens on preparers

17 Some preparers argued that the need to identify and measure liabilities that were unlikely to result in future outflows would place burdens on preparers that outweigh any benefits to investors. For example:

> The proposed approach is expected to be problematic when applied to 'reversions' of liabilities i.e. where the liability has been sold to a third party yet there remains a possibility that the obligation will revert to the prior owner in the event that the third party fails to perform. It appears that the proposals would require a probability-weighted estimate of the liability to be recognised, in contrast to the current situation where generally no liability is recognised, and indeed no contingent liability is disclosed on the basis that the likelihood is considered remote that there will be an outflow of economic resources. CL191 *BP*

> Accounting standard setters must be assured that the cost of implementing and the on-going use of such standard do not exceed the benefits derived from it (Framework, paragraph 44). With recognition possibly required for a broader population of items given the changes proposed, companies will be using resources to evaluate low-probability transactions in order to support the liability recorded. This issue is exacerbated for companies with quarterly filing requirements. We believe the removal of the probability threshold and the resulting increase in the number of obligations reported that may likely not impact future cash flow would create significant ongoing costs with little or no derived benefit. CL42 *Financial Executives International*

18 In response, it could be argued that:

(a) the entity need s to recognise and measure the expected value of a liability only if it is potentially material. The expected values of many liabilities with low probabilities of future outflows (especially those for which the likelihood of future outflows is remote) are likely to be immaterial. If the potential outflows are large enough for the liability to be material, information that quantifies the liability would be of benefit to investors.

(b) entities need to monitor and evaluate all material liabilities:

   (i) as part of their risk management processes; and

   (ii) to identify liabilities that IAS 37 requires to be recognised (probable outflows) or disclosed (possible outflows) at present.

   Any additional liabilities that they would need to recognise applying the new IFRS would be within the population whose possible outcomes need to be evaluated for other purposes.

Practical filter

19 Some respondents (in particular auditors) further argued that the probable outflows criterion is a useful filter when identifying liabilities arising from lawsuits. It is easier to apply than the 'judge whether a liability exists' criterion. In its absence, the requirements would be more complex to apply, leading to greater diversity. If—as was asserted in the IASB staff paper— removing the 'probable outflows' criterion would not affect the point of recognition for many lawsuits, there is no good reason for removing the criterion and imposing a more burdensome model in its place.

20 In response to the last point, the staff note that, although the removal of the probable outflows criterion would not affect the point of recognition for many litigation liabilities, it would affect the point of recognition for liabilities that *definitely* exist, such as the 'reversions' in BP's quote cited in paragraph 17 above.

21 The perceived difficulties of applying the 'judge whether a liability exists' criterion might be addressed by the guidance proposed in paper 8B. This guidance would demonstrate that for entities defending lawsuits, the procedures required to judge whether a liability exists would be very similar to the procedures required at present to predict the likelihood of future outflows.

Prejudicing outcomes

22 Some respondents argued that removing the probable outflows criterion could prejudice an entity's position in legal disputes:

(a) recognising a liability following a claim would become an admission of guilt, rather than a prediction of the future outcome; and

(b) recognising liabilities for unasserted claims would increase the risk of a claim being asserted.

23 This concern might be addressed by the additional guidance proposed in Paper 8B. This guidance would clarify that, as at present, recognition judgements would reflect predictions about how the courts will rule and whether the entity will offer an out-of-court settlement, *not* whether management itself believes that the entity is liable.

24 It could also be argued that recognising liabilities for unasserted claims will not increase the risk of a claim being asserted. Any potential claimant would be alerted by disclosures about the nature of the liability, not by the recognition of a number. The disclosures proposed for recognised liabilities are no more revealing than existing IAS 37 disclosure requirements for unrecognised (contingent) liabilities, including unasserted claims. Further, like IAS 37, the IFRS would permit entities not to disclose any seriously prejudicial information.

***Inconsistency with* Framework**

25 Some respondents noted that removing the probable outflows criterion would create tensions between the IFRS and the IASB *Framework*. They argued that, if the IASB wishes to change conceptual criteria in standards, it should change them only after wider debate within the conceptual framework project. Otherwise the IASB undermines the authority of the *Framework* and increases the risk of future changes to the proposed standard as a result of subsequent deliberations of the *Framework*.

> Over the years we have been consistent in urging the Board to give priority to the revision of the Framework over the development of individual standards. We believe that this inconsistency in the definition of a liability vindicates our concern that otherwise strains will develop between the Framework and individual standards with the result that the Framework will eventually have to be written to fit the standards rather than the standards based upon the Framework. We find this difficult to reconcile to the Board's view that it is developing principles-based standards. CL202 *The Hundred Group of Finance Directors*

26 The Board has accepted that removing the probable outflows will create tensions between the IFRS and the *Framework*. The Board is in the process of updating the *Framework*. However, the process is inherently lengthy and the Board is also improving individual standards in the meantime. It can be argued that improving individual IFRSs—especially in a way that better aligns them with other IFRSs—is more important than preserving consistency with all aspects of the existing 20-year-old *Framework.*

Inconsistencies with other IFRSs

27 Some respondents noted that the Board has cited consistency with other IFRSs—especially IAS 39 and IFRS 3—as a reason for removing the probable outflows criterion from IAS 37. These respondents argued that differences in the nature of the transactions, in particular for assets and liabilities acquired in a business combination—justify different requirements. In their view, the differences have not caused major problems for users or preparers. The IFRS 3 requirements for contingent liabilities are controversial: if the Board wants consistency, it should amend IFRS 3, not IAS 37.

28 The staff are not persuaded that there are differences between liabilities within the scope of IAS 37 and those within the scope of IAS 39 and IFRS 3 that necessarily justify the inclusion of a probable outflows criterion in IAS 37 but not in the other standards. However, more importantly, the staff think that the Board could clarify that it would not be removing the probable outflows criterion *primarily* to achieve consistency with other IFRSs. The Board's primary purpose would be to improve the information provided to investors about liabilities within the scope of IAS 37. The requirements of other IFRSs are relevant only because they demonstrate that the improvements proposed to IAS 37 are consistent with improvements already made to other standards.

29 The staff have possibly over-emphasised consistency with other standards when explaining the reasons for the proposed changes in the past.

Staff conclusions

30 Respondents' comments highlight significant and continuing opposition to the Board's earlier proposal to remove the probable outflows criterion from IAS 37. In the light of this opposition, the staff think that we need to continue to engage with interested parties on this proposal.

31 The staff think that some of the opposition might be attributable to differing interpretations of the implications of removing the probable outflows criterion. The additional guidance proposed in Paper 8B might help to demonstrate that the implications would *not* be as far-reaching as some respondents think they would be. If the Board wishes the staff to seek informal feedback on the draft guidance proposed in Paper 8B, we could also take the opportunity to discuss the implications of the proposed removal of the probable outflows criterion.

32 For the reasons set out in paragraphs 3-10 of this paper, the staff think that removing the probable outflows criterion would improve IAS 37 and the information provided to investors without imposing unduly onerous burdens on preparers. As explained in the staff analysis, we also think that the Board could counter the various arguments put forward against the proposal. However, we think that, if the Board tentatively re-affirms its decision to remove the probable outflows criterion, the staff should explain, and seek feedback on, the Board's reasons and do so on a timely basis. The lack of an explanation in the working draft IFRS probably contributed to a perception among some respondents that the Board had ignored the concerns they expressed in 2005.

Staff recommendation

33 Reflecting the staff conclusions above, the staff recommend that:

(a) the Board tentatively re-affirms its previous proposal to remove the probable outflows criterion from the IFRS that replaces IAS 37; and

(b) the staff engage informally with interested parties to explain, and seek early feedback on, the reasons for this tentative decision.

Question for the Board
Do you agree with these recommendations?