



Project

Liabilities—IFRS to replace IAS 37

Topic

Recognising liabilities arising from lawsuits

About this staff paper

The IASB intends to issue a new IFRS to replace IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. It has posted a working draft of the new IFRS on its website at <http://go.iasb.org/Liabilities>.

The new IFRS criteria for recognising liabilities would be different from those in IAS 37. We are aware that some people do not understand the implications of the new criteria, especially for liabilities arising from lawsuits.

This paper explains:

- how the new criteria would apply to liabilities arising from lawsuits, and
- why the IASB is changing the criteria.

The purpose of the paper is to help people obtain a high-level understanding of the new recognition criteria before commenting on the revised measurement proposals in *ED\2010\1 Measurement of Liabilities in IAS 37*. This paper is not an official pronouncement of the IASB and it is not official guidance for applying the IFRS once finalised.

This paper is not an official pronouncement of the IASB. The technical staff of the IASCF have prepared it to summarise tentative decisions made by the IASB at its public meetings. Those tentative decisions 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.

How would the new recognition criteria apply to lawsuits?

The IASB intends to remove one of three existing criteria

1. IAS 37 addresses liabilities of uncertain timing or amount that are not within the scope of other accounting standards. Such liabilities include obligations to pay fines or compensation for acts of wrongdoing. Consequently, entities defending lawsuits recognise and measure liabilities in their financial statements by applying the requirements of IAS 37.
2. IAS 37 requires an entity to recognise a liability in its financial statements if *all* of three criteria are satisfied.

Existing IAS 37 criteria for recognising a liability

- ❶ The entity has a present obligation.
- ❷ It is probable (more likely than not) that an outflow of resources will be required to settle the obligation.
- ❸ A reliable estimate can be made of the amount of the obligation.

3. The IASB intends to remove criterion ❷. As a result, entities would recognise all present obligations that can be measured reliably.

Removing this criterion would *not* require entities to recognise liabilities for all lawsuits.

4. Removing criterion ② would not require entities to recognise liabilities for all lawsuits. This is because the lawsuits might not satisfy the other recognition criteria. In particular, the existence of a lawsuit does not necessarily mean that the entity has a present obligation (criterion ①). An entity has a present obligation only if, and to the extent that, the claim against it is valid.
5. Typically, in a disputed lawsuit, it is uncertain whether the defendant has a present obligation. As under the existing IAS 37, management would need to consider the available evidence and to reach a judgement as to the validity of the claim. Paragraph 14 of the working draft IFRS lists examples of the types of evidence that management would consider. The evidence might include:
 - (a) reports from those investigating the claim (which might provide evidence of whether alleged events occurred), and
 - (b) legal opinions (which might provide evidence of how the law applies to those events).

Example

Five people die while taking a new drug. Their families commence legal proceedings against the pharmaceutical company that developed the drug.

The company complied with applicable drug testing and approval requirements before launching the drug. The tests identified dangers associated with the drug but the company's directors believe that the company complied with requirements for disclosing the dangers.

The directors consider all of the available evidence, including the opinions of lawyers. On the basis of this evidence, they judge that the families do not have a valid claim for compensation from the company. Therefore, the company does not recognise a liability in its financial statements.

Entities would not necessarily recognise more liabilities than at present

6. At present, many preparers of financial statements focus on criterion ② when judging whether to recognise a liability for a lawsuit. Without this criterion, the focus would shift from predicting the likely outcome to judging whether the entity has an obligation.
7. However, in many cases, the change in focus would not affect the recognition decision. This is because the likely outcome and the existence of an obligation both depend upon the same factor, ie the strength of the claim against the entity. In other words, if lawsuits fail criterion ②, they typically also fail criterion ①. Without criterion ②, entities would not necessarily recognise more liabilities than they recognise when applying IAS 37 at present.

Only in limited circumstances would entities recognise more liabilities

8. An entity would recognise a liability when applying the new IFRS that it does not recognise when applying IAS 37 *only* if:
 - (a) criterion ① is satisfied—the available evidence suggests that the entity *has* an obligation to the plaintiff; but
 - (b) criterion ② is not satisfied—the probability of *any* payment being required to settle the obligation is less than 50 per cent.
9. *Such circumstances might be relatively rare.* If an entity judges that a claim against it is valid, how often will the available evidence support a prediction that it is not probable that *any* payment (even a small payment) will be required to settle the claim?

Some entities might recognise fewer liabilities

10. The converse situation could arise. The available evidence might suggest that the entity *does not have* an obligation, but management might nevertheless predict that the entity probably *will* make some payment to the counterparty. This situation could arise if the entity:
 - (a) expects a court judgement that is inconsistent with the evidence; or
 - (b) intends to offer an out-of-court settlement as a cost-efficient alternative to defending the claim.

11. At present, entities apply different interpretations of IAS 37:
 - (a) some entities do not recognise a liability on the grounds that criterion ❶ is not satisfied. Although there might be a future payment, it would arise from a future obligating event (the future court judgement or a future binding agreement to settle out of court). The possible future payment does not arise from a present obligation.
 - (b) other entities do recognise a liability on the grounds that a future payment is probable and would relate to a past event (the claim from the plaintiff).

12. The new IFRS would eliminate these differences in interpretation. It would require entities to follow the approach in paragraph 11(a). In other words, if a realistic assessment of the evidence leads to a conclusion that the claim has no merit, the entity would not recognise a liability. Instead it would disclose information about the case. The disclosure requirements would be similar to those for contingent liabilities in the existing IAS 37.

13. Consequently, entities that apply the approach in paragraph 11(b) at present might recognise fewer liabilities when applying the new IFRS. However, this situation might arise less frequently than some people expect. Predictions of adverse outcomes or out-of-court settlements are often made on the basis of experience of similar claims. Repeated experience of such outcomes would be evidence that the claims do have some validity, even if the entity settles them without ever admitting liability. If required to make a realistic assessment of the claims, management might accept that some are likely to be valid. In such cases, the entity would continue to recognise some liabilities when applying the new IFRS.

Worse than expected outcomes would not mean that previous judgements were wrong

14. Management would decide whether to recognise, or not recognise, a liability by judging the evidence available when it prepares the financial statements for a given period. In later periods, as the case progresses and new evidence becomes available, the judgements might change, and the eventual outcome could be different from that previously expected. A worse than expected outcome for the case would not mean that earlier judgements were inappropriate when they were made.

The entity would not need to disclose amounts recognised for individual cases

15. As under the existing IAS 37, entities would be required to disclose information about recognised liabilities *in aggregate* for each class of liability. Entities would not need to identify amounts for individual cases. Additionally, as under the existing IAS 37, entities would be exempted from disclosing any seriously-prejudicial information.

Why is the IASB changing the criteria?

Entities should recognise all of their liabilities

16. To provide useful information to users of their financial statements, entities should recognise all of their liabilities.
17. The removal of criterion ② would apply this principle to liabilities within the scope of IAS 37 and align the requirements of the new IFRS with those of other IFRSs. As a result:
 - (a) the recognition criteria for liabilities within the scope of IAS 37 would be the same whether the liabilities have been assumed in a business combination (and hence are addressed by IFRS 3 *Business Combinations*) or have arisen in other circumstances (and hence are addressed by IAS 37). The IASB removed criterion ② from IFRS 3 when it revised that IFRS in 2008.
 - (b) the recognition criteria for liabilities such as guarantees would be the same whether the liabilities are within the scope of IAS 37 or within the scope of IAS 39 *Financial Instruments: Recognition and Measurement*.

Entities would not recognise liabilities for legal claims that lack merit

18. In 2005, when the IASB first proposed to remove criterion ② from IAS 37, it also proposed that the start of legal proceedings creates an obligation satisfying criterion ① in all circumstances.
19. In combination, the two proposals would have required entities to recognise liabilities for *every* lawsuit, ie whatever the merits of the case and whatever the likely outcomes. Many respondents opposed the proposals. They disagreed with the conclusion that the start of legal proceedings gives rise to an obligation. They also argued that a requirement to recognise ‘unlikely to happen’ risks would not result in relevant information for capital providers, and would impose excessive burdens on preparers of financial statements.
20. In 2006, the IASB reconsidered its proposals in the light of the comments received. It decided that the start of legal proceedings does *not* give rise to an obligation. An obligation arises only from an act of wrongdoing that gives the plaintiff a valid claim against the entity. Accordingly, the IASB has withdrawn the proposal that all lawsuits give rise to obligations. The new IFRS—like the existing IAS 37—would require an entity to judge whether it has an obligation to the plaintiff. As explained earlier in this paper, entities would not necessarily recognise more liabilities when applying the new IFRS than they recognise when applying the existing IAS 37. In some cases, they would recognise fewer liabilities.
21. The IASB has thus addressed the main objection to the proposal to remove criterion ②. The IFRS would not require entities to recognise liabilities for claims that lack merit.

The new approach would provide relevant information to capital providers

22. Removing criterion ② would focus recognition decisions on judgements about whether a liability exists, not on predictions of the most likely outcome of the case. Other changes in the IFRS would reinforce this new focus—in particular, the IFRS would require entities to measure liabilities taking into account all possible outcomes, not only the most likely outcome.
23. Some people have questioned the change in focus. They suggest that the most relevant information for capital providers is the entity's prediction of the most likely future cash flows. Consequently, an entity should recognise a liability only if a future payment is probable, ie only if criterion ② is satisfied.
24. The IASB does not agree with this view. The IASB notes that the objective of capital providers is to receive returns on, and returns of, their interests in the reporting entity. The value of the capital providers' interests depend on the amount, timing *and uncertainty* of the entity's future cash flows, ie it takes into account all of the entity's existing obligations and the range of possible future cash flows for each, not only the most likely cash flows.

The new approach is workable in practice

25. Some people have suggested that, whatever the conceptual merits of the new approach, the existing focus on the likely outcome is more workable and reliable, because it follows the approach that entities typically use to manage their lawsuits.
26. However, the new approach should not require major adjustments to existing financial reporting procedures. As explained in paragraph 7 above, the judgements required to apply the new IFRS would be similar to those required to apply IAS 37.

The IASB can improve individual standards in advance of changes to the conceptual framework

27. The IASB's *Framework for the Preparation and Presentation of Financial Statements* states that liabilities should be recognised only if it is probable that an outflow of resources will result from the settlement of the obligation. Consequently, removing criterion ② from IAS 37 will create tensions with the *Framework*. Some people have argued that the IASB should not remove the criterion from IAS 37 unless and until it has undertaken the due process required to remove it from the *Framework*.
28. The IASB is in the process of updating the *Framework*. However, the process is inherently lengthy and in the meantime the IASB is also improving individual standards. The IASB regards aligning IAS 37 with other IFRSs—so that all liabilities are recognised—as more important than preserving consistency with all aspects of the existing 20-year-old *Framework*.

The IASB is not inviting comments on the change to the recognition criteria because it invited comments on this change in 2005

29. The IASB is at present re-exposing for further comment one section of the new IFRS. That section sets out revised proposals for measuring liabilities.¹
30. The IASB has also posted the working draft of the entire IFRS on its website to allow interested parties to see the revised measurement proposals in the context of the IFRS as a whole. The IASB is *not* inviting further comments on other aspects of the draft IFRS, such as the recognition criteria. This is because it has previously invited comments on those other aspects—all the main changes of substance from the existing requirements of IAS 37 were proposed in the 2005 exposure draft. The Board has considered the comments it received on the 2005 exposure draft in reaching its final decisions on the IFRS. It will explain its decisions in the Basis for Conclusions accompanying the IFRS.

¹ Exposure Draft ED/2010/1 *Measurement of Liabilities in IAS 37*, January 2010.