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Geschillen in de jaarrekening: verwerking en vermelding van risico's in verband met claims, juridische geschillen en rechtsgedingen volgens het Nederlandse jaarrekeningenrecht

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9 Litigation in the financial statements summary, conclusions and recommendations

9.1 Summary

This dissertation investigated how to deal with contingencies in the financial statements in reporting practice: uncertain events resulting from present operations with possible future financial impact. This investigation deals with uncertain risks related to claims, legal disputes and law suits (litigation) as example of contingencies. Claims, legal disputes and law suits demand continuous estimations of risks to legal processes and their possible financial impact from the liable company. It depends on these estimations whether a contingent liability has to be included in the financial statements, the size of it and which information has to be given in order to meet the legal requirements. Therefore estimations are an important subjective element in the financial statements. Too pessimistic estimations may lead to cover the costs too early and to a too low result. Too optimistic estimations may lead to too low costs and a too high result. In certain circumstances the management may have an interest in allocating the result to a certain financial year by pessimistic or even by optimistic estimating, even though the result could have been allocated to another financial year. This is a kind of earnings guidance created by whether or not recognising a provision. In earlier investigations indications have been found that decisions could be earnings guiding by recognising a provision. For this reason the influence on the financial statements of estimations due to litigation have been limited under US GAAP (rules based). Also under IAS 37 specific regulations have been included for the recognition of litigation in the financial statements.

The thesis of this dissertation is:

How to deal with the risks related to claims, legal disputes and law suits according to the Dutch accounting law and their proportionality with the reporting practice of the fifty largest companies whose shares are listed in the NYSE Euronext Amsterdam.
Are (more) detailed rules and regulations needed?

In order to answer the thesis, the following three research questions have been formulated.

Research question 1 is:

How to deal with the risks related to claims, legal disputes and law suits with which the company is confronted in its operations according to the Dutch accounting law.

Research question 1 is carried out on the basis of a normative research.

After implementation of the Fourth Directive the accounting law has been included under Title 9, Book 2 of the Dutch Civil Code. According to the objective of article 2:362 of the Dutch Civil Code the financial statements are aimed to provide insight and a true and fair view. In the term true and fair view there is a central role for the Guidelines, which have the status of important source of knowledge of generally accepted standards, according to established case law. The conditions in Guidelines 252 for recognising provisions are strongly influenced by IAS 37 of IASB. Title 9 has also been adapted to the standards of IASB (the Modernising Directive). The

standards of IASB, which have been approved by the European Commission, are directly applicable to consolidated financial statements of companies whose shares are listed in the NYSE Euronext Amsterdam (IAS-regulation).

In the implementation of the Fourth Directive the legislator laid down that also a provision has to be recognised for clear risks. In 2005, after the adaption to the Modernising Directive, there has to be a probable liability, according to Article 2:374, section 1, of the Dutch Civil Code:

The balance sheet includes provisions to cover liabilities, the nature of which is clearly defined and which are probably to be incurred at the date of the balance sheet but uncertain as to the amount or as to the date on which they will arise.

By incorporating the word 'probably' in the legal text the risk provisions have not yet been disappeared after 2005. According to Hoogendoorn (1997) a probable chance is in case of a degree of assurance between 50% and 95%.

According to IAS 37 risks related to claims, legal disputes and law suits have to be dealt with as follows:

IAS 37.14, a provision shall be recognised when:

- (a) an entity has a present obligation (legal or constructive) as a result of a past event;
- (b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and
- (c) a reliable estimation can be made of the amount of the obligation.

In respect of claims, legal disputes and law suits, the specific regulation of IAS 37.16 applies:

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 opinions 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, unless the possibility of an outflow of resources embodying economic benefits is remote (..).

In 2005 both IASB and FASB started a convergence project with the aim of adapting IAS 37. A new definition 'liability' was proposed, which would be extended with the so called state 'ready obligations', whereas the definitions 'contingency' and 'provision' would disappear. This proposal has drawn a lot of criticism as this would be an artificial term that is not included in the legal concepts. The result of the proposed adaption is, that only on submitting a claim to the liable company leads to a liability as the company has to comply with any ruling delivered by the court. In combination with the proposal to cancel the standards of probability of IAS 37.14 and 37.16 this means that also (frivolous) claims, where the chances of success are unlikely for the claimant party, have to be recognised as a liability in the financial statements. Even the proposal to value stand-alone liabilities, as claims, legal disputes and law suits at the weighted average of the expected cash outflow (expected value method) is controversial. This is a complex valuation method which can lead to less relevant and less reliable information at the assessment of legal disputes. In 2015, at the moment

of concluding the manuscript of this dissertation, the debate on the revision of IAS 37 has shifted to the proposals for revisions of the Conceptual Framework.

In case the fiscal principles are to be used (micro and small entities) it is important that the fiscal case law sets other requirements for the recognition of provisions than the Guidelines. Besides the requirements of origin, the requirements of causal allocation and of reasonable chance of success have been set. The requirements have been analysed on the basis of fiscal case law. A notable difference with the civil law rules is that a probability test is lacking at the requirement of a reasonable chance of success. After studying the literature concerning the desirability to introduce one profit concept, it is my opinion that IFRS could serve as inspiration for the development of the fiscal profit concept. The details have to be left to justice. For the test whether a provision may be recognised fiscally, it is recommended that the court tests expressly for compatibility with the criteria of IAS 37. That does not mean, that the requirements of IAS 37 should determine the fiscal profit concept. It is conceivable that fiscally a provision may be recognised, without satisfying the criteria for probable chance of success (>50%). This can be justified by the liquidity aspect and the principle that the benefit of the doubt should be owned by the government for the estimation of specific risks related to claims, legal disputes and law suits. It is undesirable that fiscal interests have a role in the development of IAS.

Research question 2 is:

How are the risks related to claims, legal disputes and law suits resulting from operations approached in the financial statements of the largest companies whose shares are listed in the NYSE Euronext Amsterdam.

The results of the research of the financial statements have been identified in chapter 7. The research shows that 81% of the researched population has made a provision in relation to the risk of claims, legal disputes and law suits (AEX 87% and AMX 74%) and 90% has disclosed a contingent liability in relation to claims, legal disputes and law suits (AEX 96% and AMX 84%).

Subsequently a study was conducted to what extent the information elements from IAS 37.84-85 have been satisfied in the notes to the specific provisions:

The nature of the specific provision has been disclosed in 38% of the cases (AEX 50% and AMX 21%).

Quantification of the risks of specific provisions has been taken place in 76% of the cases (AEX 80% and AMX 71%).

A statement of movements of the specific provision has been made in 56% of the cases (AEX 70% and AMX 36%).

In one way or another the legal dispute has been followed in the notes in 29% of the cases (AEX 30% and AMX 29%).

A study was also conducted to what extent the information elements from IAS 37.86 have been satisfied in the notes to the contingent liabilities:

The nature of the disputes for which a contingent liability has been recognised, has been disclosed in the notes 79% of the cases (AEX 82% and AMX 75%).

Quantification of the risks of disputes has been taken place in 55% of the cases (AEX 64% and AMX 44%).

A statement which follows the financial flow of the risks has been given in 42% of the cases (AEX 41% and AMX 44%).

In one way or another the dispute has been followed legally in the notes in 55% of the cases (AEX 73% and AMX 31%).

Research question 3 has been covered in chapter 8.

Research question 3 is:

To what extent the accounting rules of IAS 37 regarding claims, legal disputes and law suits are respected in the financial statements of the largest companies whose shares are listed in the NYSE Euronext Amsterdam.

The answer to research question 3 gives information about the degree of compliance: to what extent the deal of risks regarding claims, legal disputes and law suits in the financial statements is compliant with the applicable rules and regulations. The research on compliance has been carried out among companies whose shares are listed in the NYSE Euronext Amsterdam AEX and AMX, with which the regime of IAS 37 is applicable. Compliance is identified in processing rules (recognition), whether a provision or a contingent liability is required according to IAS 37 and to what extent the required information elements have been satisfied (disclosure) according to IAS 37.

Recognition

The question whether a specific provision has to be recognised regarding risks of claims, legal disputes and law suits, requires a number of subjective assumptions to which, according to IAS 37.16, the opinion of experts should have a role as proof of the present obligation as at balance sheet date. An important role here is for the expert per excellence, the (regular) lawyer for the company that produces the financial statements. The lawyer has also a role at the estimation of the chance that the obligation only could be settled by an outflow of resources and at the estimation of the amount of the obligation. All this requires an accurate estimation of the chances in court.

According to the Nederlandse Orde van Advocaten contingencies concerning litigation cannot be estimated justifiably. It appears that by this the practice has to face a dilemma in reporting risks regarding claims, legal disputes and law suits. In order not to damage the relationship of trust between client and lawyer, the lawyer is obliged to give no concrete answer to the questions about the chances in court under the professional rules with a so called lawyers' letter. The answer of the lawyer has to be limited to objective data, such as the description of the litigation, the state of the litigation and the indication of what has been legally claimed. Therefore it is hard for the auditor to assess whether a recognised provision concerning risks of claims, legal disputes and law suits is compliant to rules and regulations. In spite of this dilemma, from the empirical research it appears that in 81% of the surveyed population with claims, legal disputes and law suits a specific provision has been recognised (AEX 87% and AMX 74%).

Disclosure

Subsequently a study was conducted whether the information elements from IAS 37.84-86 have been satisfied. Even when the notes to the specific provisions and to the contingent liabilities are read in conjunction, there are still companies who do not disclose all information elements in the financial statements. To the specific provision the description of the nature of the liability to which a provision has been recognised has not been disclosed in 18% of the cases (AEX 5% and AMX 36%). The quantification of the risk has not been made in 6% of the cases (AEX 0% and AMX 4%). An autonomous statement of movements is not present in 24% of the cases (AEX 15% and AMX 36%), although in all cases a combined survey was given. A description of the legal state has not been disclosed in the notes in 32% of the cases (AEX 15% en AMX 57%). In the notes to the contingent liabilities the nature of the liability has not been disclosed in 18% of the cases (AEX 9% and AMX 31%). The risk has not been quantified in 16% of the cases (AEX 14% and AMX 19%). The financial flow of the litigation has not been disclosed in 29% of the cases (AEX 27% and AMX 31%) and the legal progress of the litigation has not been disclosed in 37% of the cases (AEX 23% and AMX 50%). No indications has been found in the research of the financial statements that in the cases where not all information elements have been satisfied, the exemptions for disclosures applied.

9.2 Conclusions

Chapters 4 and 7 are the core of this dissertation. Chapter 4 covers the deal of risks regarding claims, legal disputes and law suits according to IAS 37. Chapter 7 covers the research of financial statements of companies whose shares are listed in AEX and AMX. By confronting the results of chapter 4 with the results of chapter 7 the question to what extent the regulations of IAS 37 have been complied with is researched in chapter 8.

This makes it possible to answer the last part of the problem definition as far as IAS 37 is applicable:

Are (more) detailed rules and regulations needed?

IAS 37 provides specific requirements for the recognition and disclosure of contingencies, more particularly for risks regarding claims, legal disputes and law suits. IAS 37 contains a practical guidance for the reporting practice which includes two probability thresholds:

- it has to be more likely than not that a present obligation exists, and
- it has to be more likely than not that the obligation will lead to an outflow of resources (probability requirement > 50%).

The proposed revision of IAS 37 in ED 2005 in which these practical thresholds are under pressure, has met with a lot of criticism. Meanwhile the debate has been shifted to the ED 2015 for the revision of the Conceptual Framework. It seems that now there is more attention to the specific nature of the contingent liabilities of IAS 37 as to claims, legal disputes and law suits.

The subjective estimates of the probable chance have to be supported by experts' judgements. Based on the professional rules the expert per excellence, the regular

lawyer, is not obliged to share concrete chances of success with the auditor. Despite this dilemma for the reporting practice, it is remarkable that 81% of the companies whose shares are listed in AEX or AMX, has recognised a specific provision for claims, legal disputes and law suits.

In chapter 7 the financial statements of companies whose shares are listed in AEX and AMX, have been researched in detail to the extent to which the information requirements have been satisfied. This detailed research enables other than conclusions on a higher level, also conclusions on a detailed level. Seen from a higher level, the regulations concerning the information provision have been satisfied reasonably well. It is important to note that there is a problem with the classification: it appears that information that should have been noted to the item provisions, has been noted frequently to the contingencies without explicit reference to this in the notes to the provisions. On a more detailed level it appears that in case of some companies there are some deficiencies. The required provision of information has not been fully satisfied, even when the information with the provision is considered in conjunction with the information with the contingencies. This means, that on a detailed level a specific provision not always has been disclosed, whereas by definition information on risks regarding claims, legal disputes and law suits is relevant. Therefore more attention is needed from the auditors to be compliant with the regulations of IAS 37.

Recommendations

From the normative research in chapters 2 to 6 and from it's confrontation with the research of the annual accounts in chapters 7 and 8 the following recommendations have been derived:

The probability test of IAS 37.16 works as an important treshold for the recognition of a provision regarding litigation and should be retained.

According to IAS 37.16 the recognition of a provision regarding contingencies has to be substantiated. The proposal of ED 2005 to cancel the probability test, to recognise a provision at any time in case of a litigation and to take account of the (process) chance in the valuation of the provision infringes that.

The development of the civil profit concept may not be influenced by fiscal interests. The fiscal profit is based on the same principles as those of the IFRS, but can deviate due to differences in emphasis. It is up to the courts to judge and to explicitly indentify these differences.

In case the requirements for the recognition of a provision regarding litigation have not been satisfied, the management has to conduct a benefits eligibility test identifying potential future outflow regarding compensation or settlement of liabilities related to litigation. To the estimated amount no distributions may be paid without risk to the director's liability.

In case a provision has been recognised regarding litigation, this provision has to be fully disclosed in the notes. Insight has to be given about all information elements, giving separate insight in the recognition, the release and the use of the provision regarding litigation.

In case there are contingencies, the information elements of IAS 37 have to be fully satisfied. The accent should be put on information that can be established objectively and actually.

