# Report on gaap accounting treatment for contingencies

Finance, Investment

Treatment of contingencies has gained significance in the wake of mergers and acquisitions prompted by recessionary trend and exposure to Sarbanes-Oxley Act (SOX) and as part of risk-management.

Accounting Standards Codification (ASC) 450 applies to “ Contingencies”. It relates to both the contingencies of loss and gain. Except for the carry forward of tax loss, gain contingencies are not recognized since it is not apt to be recognized before actual realization. US. GAAP does not allow recognition of contingent assets and only requires brief disclosure when a future gain is likely to be realized. However, loss contingencies can be recognized. They relate to items that could result in liabilities and assets that are impaired. As the principle of conservatism, the loss contingences are recognized generally when they are likely to occur and the amount of loss can be reasonably estimated. Both loss contingencies that are recorded as well as not recorded should be necessarily disclosed. Instances of contingent liabilities are outstanding or threatened litigation, claims and assessments, product warranties and defective product claims. Contingencies involving impairment include defaulting receivables and impending expropriation of assets. Loss contingencies are quite uncertain and are not easy to estimate and their treatment differs according to the degree of probability. While disclosure in the form of footnotes is sufficient in some cases, in others accruals and recognition must be on the face of the financial statements. As a first step, the entity should decide on accounting it or otherwise by verifying existence of the given contingency. Secondly, if existence is established, the entity should judge its existence “ from remote to reasonably possible to probable”. Third step is for the entity to carry out the

actions below: (a) if a loss has probably occurred on a particular date of financial statements and the amount involved can be estimated with some accuracy, the entity must accrue the loss and disclose the fact. The aim of this test is to recognize in the current period’s financial statement when loss relating to previous or current period can be estimated reasonably. (b) If it is not possible to ascertain that loss has been occurred or it cannot be estimated, the entity should only disclose the relative information. (c) If there is only a remote possibility of loss, does not accrue or disclose loss contingency except in the case of guarantees. In case of disclosure, the entity should do so in the form of notes to financial statement mentioning nature of accrual and amount of accrual if nondisclosure of it would be taken as misleading feature in financial statements. US GAAP uses higher threshold for accrual “ likely to occur” as against the IFRS prescription that accrual should be resorted to when the “ likelihood of the event occurring is more likely than not” (p 3). Difference in treatment of contingencies between U. S. GAAP and IFRS are: In terms of “ standard”, definition of “ probable” in the former is “ likely’ and the latter “ more likely than not”. In terms of “ amount of range of outcomes”, the former requires “ minimum in range “ while the latter requires “ midpoint in range”. As for “ discounting”, the former “ generally does not allow discounting” whereas the latter “ requires that the liability be discounted”. There is no disclosure exception” in the former whereas the latter allows exception if there will be “ serious prejudice to the entity” In a nutshell, loss contingencies are prevalent in the forms of “ litigation, environmental liabilities, guarantees and product warranties” .

# References

Schiff, J., Schiff, A., & Rozen, H. (2012). Accounting for Contingenices:

Dislcosure of Future Business Risks. Management Accounting , 13 (3), 1-8.