LESSON 3: CURRENT LIABILITIES
AND CONTINGENCIES CASE
STUDY
Lesson Three: Current Liabilities and Contingencies Case Study

The purpose of this activity is to expose students to the varying treatment of specific items under U.S. GAAP versus IFRS. This activity will focus on accounting for current liabilities and contingencies.

As you know, a contingency is an event with uncertain outcomes that may represent potential liabilities. A contingency that results in a gain under both U.S. GAAP and IFRS is generally disclosed in the footnotes until realized, however losses that meet the criteria specified under U.S. GAAP or IFRS guidance must be recognized in the financial statements. In general, both IFRS and U.S. GAAP have similar recognition criteria for contingencies recognized as a liability; however, the point at which the accrual of a loss contingency is recognized in the financial statements may be interpreted differently under the two standards.

Part 1: Guidance

Below shows the specific guidance for recognition of a loss contingency in the financial statements as a liability and expense or in the notes to the financial statements under U.S. GAAP and IFRS.

U.S. GAAP

Statement of Financial Accounting Standards No. 5 (SFAS No. 5) states that “an estimated loss from a contingency shall be accrued by a charge to income if both of the following conditions are met:

1. Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements…
2. The amount of loss can be reasonably estimated.”

Also under SFAS No. 5, disclosure of loss contingencies should be made “if no accrual is made for a loss contingency because one or both of the conditions listed above are not met...disclosure of the contingency shall be made when there is at least a reasonable possibility that a loss or an additional loss may have been incurred.”

SFAS No. 5 defines probable as “the future event or events are likely to occur” and reasonably possible as “the chance of the future event or events occurring is more than remote but less than likely” where remote is defined as “the chance of the future event or events occurring is slight.”

IFRS

IAS 37, Provisions, Contingent Liabilities, and Contingent Assets, distinguishes between a provision and a contingent liability. If the transaction qualifies as a provision, it is formally recognized in the financial statements, and if it qualifies as a contingent liability, it is disclosed in the notes to the financial statements. Formal guidance from IAS 37 relating to provisions and contingent liabilities are shown below.
Provisions are those liabilities for which amount or timing of expenditure are uncertain. A provision should be recognized if:

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

IAS 37 sets the threshold for accrual and defines probable as “more likely than not”. If the obligation is more likely to exist than to not exist, it will need to be formally recognized as a provision if an amount can be reasonably estimated for it.

Contingent liability is an obligation that is either:

- A possible obligation arising from past events, the outcome of which will be confirmed only on the occurrence or nonoccurrence of one or more uncertain future events which are not wholly within the control of the reporting entity; or
- A present obligation arising from past events, which is not recognized either because it is not probable that an outflow of resources will be required to settle an obligation or the amount of the obligation cannot be measured with sufficient reliability.

A reporting entity is not to give formal recognition to a contingent liability. Instead, it should disclose in the notes to the financial statements the following information:
1. An estimate of its financial effect
2. An indication of the uncertainties relating to the amount or timing of any outflow; and
3. The possibility of any reimbursement.

Whether recognized in the financial statements or in the notes to the financial statements, the entity needs to record an estimate of the amount of the possible future obligation. Under IAS 37, this should be the company’s best estimate, at the end of the reporting period, of the amount of expenditure that will be required to settle the obligation. This is often referred to as the “expected value” of the obligation, which may be operationally defined as the amount the entity would pay, currently, to either settle the actual obligation or provide consideration to a third party to assume it.

Therefore, U.S. GAAP defines probable as “likely” and IFRS defines probable as “more likely than not”. In general, under U.S. GAAP “likely” has been interpreted as greater than a 70% chance of occurring and under IFRS “more likely than not” has been interpreted as more than a 50% chance of occurring.

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1 This information is obtained from the Ernst & Young LLP 2009 “Current Liabilities and Contingencies” Academic Resources on IFRS
**Part 2: Questions**
Using the information above, complete the following questions.

1.) When should a contingency be recognized as a contingency in the financial statements or in the notes to the financial statements under U.S. GAAP and IFRS? How is the guidance for a contingency under U.S. GAAP similar to IFRS? How is it different?

2.) After a wedding in 2010, 10 people died as a result of food poisoning from products sold by Kiss Catering Inc. (KCI). Legal proceedings started, seeking damages from the company. Up to the date of authorization of the financial statements for the year ended December 31, 2010, the company’s lawyers advised that it was 40% probable that the company would not be found liable. However, when the company prepared its financial statements for the year ended December 31, 2011, its lawyers advised that, owing to developments in the case, it was 85% probable that the company would be found liable.

   a. Assuming the attorneys can arrive at a reasonable estimate of the potential damages, should KCI recognize a provision using U.S. GAAP in 2010 and in 2011?
   b. Should KCI recognize a provision using IFRS in 2010 and in 2011?
   c. If you were a user of financial statements comparing two companies with a similar transaction, but one company operated under U.S. GAAP and the other operated under IFRS, as it relates to this transaction, how would their income statement and balance sheet differ?

When there is a continuous range of possible outcomes and each point in the range is as likely as any other to occur, under U.S. GAAP (FASB Interpretation No. 14), the minimum amount in the range is used to measure the provision. Under IFRS (IAS 37), the midpoint of the range is used.

Using this information and the information above, complete the following questions:

3.) Although we noted that in general under U.S. GAAP “likely” has been interpreted as greater than a 70% chance of occurring and under IFRS “more likely than not” has been interpreted as more than a 50% chance of occurring, it is not formally written in the standards what the appropriate interpretation of “likely” and “more likely than not” should be. What would be your range of possible percentages for the phrases “likely” and “more likely than not”? As discussed in Lesson 1, U.S. GAAP is known to be more “rules-based” and IFRS is known to be more “principles-based”. Given the guidance above, do you think U.S. GAAP or IFRS is more rules-based when it comes to accounting for contingencies?

4.) In general, when accounting for contingencies which treatment (U.S. GAAP versus IFRS) better meets the definition of conservatism? Which treatment provides companies more room for earnings management? Which treatment provides more transparent figures? Which treatment allows more comparability across countries? Which treatment do you prefer and why?