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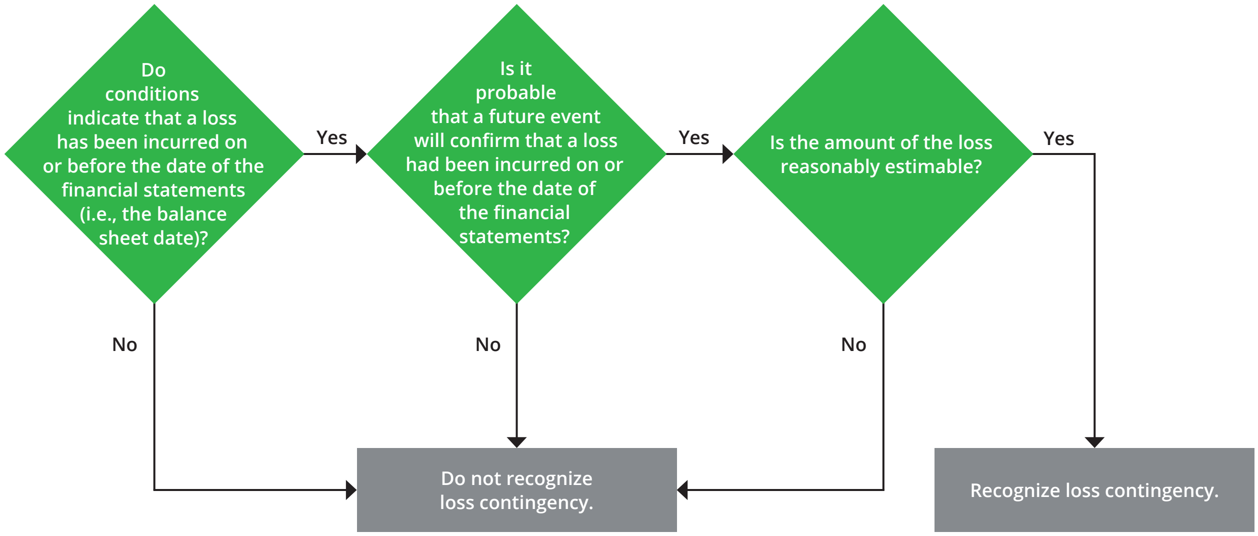
On the Radar

Contingencies, Loss Recoveries, and Guarantees

Although the guidance in ASC 450 on accounting for contingencies has not changed significantly for decades, it is often challenging to apply because of the need for an entity to use significant judgment in doing so (e.g., when developing legal interpretations). Similarly, the guidance in ASC 460 on accounting for guarantee liabilities, which has existed for two decades, is often difficult to apply because the determination of whether an arrangement constitutes a guarantee is complex.

Contingent Liabilities

An entity must recognize a contingent liability when both (1) it is probable that a loss has been incurred and (2) the amount of the loss is reasonably estimable. In evaluating these two conditions, the entity must consider all relevant information that is available as of the date the financial statements are issued (or are available to be issued). The flowchart below provides an overview of the recognition criteria, taking into account information about subsequent events.



If the recognition criteria for a contingent liability are met, entities should accrue an estimated loss with a charge to income. If the amount of the loss is a range, the amount that appears to be a better estimate within that range should be accrued. If no amount within the range is a better estimate, the minimum amount within the range should be accrued, even though the minimum amount may not represent the ultimate settlement amount. Discounting contingent liabilities is generally prohibited.

Common Pitfall

Entities often fail to recognize a contingent liability even when they have made a substantive offer to the plaintiff to settle the litigation. An offer to settle litigation is presumed to constitute evidence that a loss has been incurred and that the offer amount represents the low end of the range of loss, resulting in the need to accrue a contingent liability for at least this amount. It is extremely difficult to overcome this presumption even if an entity withdraws the offer before the financial statements are issued (or are available to be issued).

Entities must disclose information about contingent liabilities unless the likelihood of a loss is remote. The disclosures required by ASC 450-20 may include information about the following:

Recognized Contingent Liabilities	• Nature of the contingency • The amount of the loss recognized • Indication that it is reasonably possible that the estimated loss will change • The exposure to loss in excess of the amount accrued as a liability
Unrecognized Contingent Liabilities	• Nature of the contingency • An estimate of the possible loss or range of possible loss or a statement that such an estimate cannot be made • Indication that it is reasonably possible that the estimated loss will change

The SEC staff has consistently commented on and challenged registrants' compliance with the disclosure requirements for loss contingencies. For example, the staff has often challenged registrants when they recognize material contingent liabilities but have not disclosed information about such possible losses in prior filings. The staff also often asks about estimates of reasonably possible losses or comments when a registrant omits disclosure of a loss or range of losses because its estimates lack precision and confidence.

Contingent Gains and Loss Recoveries

The accounting for contingent gains differs significantly from the accounting for loss recoveries. Most notably, loss recoveries may be recognized earlier than gain contingencies. A gain contingency cannot be recognized before it is realized or realizable.

Recognition of a gain contingency occurs at the earlier of when:

The gain has been realized

The gain is realizable

Recoveries of recognized losses (e.g., insurance recoveries) may be recognized when it is probable that they will be received and the amount is reasonably estimable. However, such recoveries cannot be recognized in amounts that exceed the recognized losses because such an excess represents a gain contingency. It is often difficult to determine whether an amount to be received represents a loss recovery, a gain contingency, or a combination of both.

Guarantee Liabilities

Four types of contracts represent guarantees under ASC 460:

The determination of whether an arrangement qualifies as one of these types of contracts is often difficult because there is limited interpretive guidance on each type; an entity will therefore need to use judgment in making this determination. Further, because ASC 460 only discusses the characteristics of each type of guarantee contract, entities often focus on ASC 460's examples of the types of contracts that meet the definition of a guarantee in determining whether a contract is subject to ASC 460. To make matters even more complex, there are a number of scope exceptions related to applying the recognition guidance, disclosure guidance, or both.

Guarantee liabilities must be initially recognized at fair value. A fair value estimate for such liabilities will include an amount for an entity's stand-ready (noncontingent) obligation that it assumes when the contract is issued. However, ASC 460 does not address the subsequent measurement of such liabilities other than to require that an entity apply the guidance on contingent liabilities to any contingent loss arising from the contract. As a result, an entity needs to adopt accounting policies that address both (1) the release of the liability recognized at the inception of the contract and (2) the accounting for contingent losses that arise, including how the recognition of those losses intersects with the previous recognition of the amounts for the noncontingent component. Because of the lack of specific guidance on this topic, diversity in practice exists.

In addition to the disclosure requirements for contingent liabilities in ASC 450-20, entities must comply with ASC 460's disclosure requirements that specifically apply to guarantees.

Product Warranties

ASC 460 includes specific guidance on warranty obligations incurred in connection with the sale of goods or services (i.e., product warranties). All product warranties are within the scope of the disclosure requirements in ASC 460; however, certain product warranties are outside the scope of ASC 460's recognition and measurement guidance and are accounted for in accordance with ASC 606. The recognition and measurement of product warranties that are within the scope of ASC 460 differs from the general recognition and measurement guidance that applies to guarantees.

Assurance-Type Warranty	• Recognition and measurement: ASC 460 • Disclosure: ASC 460
Service-Type Warranty	• Recognition and measurement: ASC 606 • Disclosure: ASC 460

Common Pitfall

An entity accounts for an arrangement as an assurance- or service-type warranty when it meets the definition of a guarantee obligation that is subject to the general recognition and measurement guidance in ASC 460.

See Deloitte's Roadmap *Contingencies, Loss Recoveries, and Guarantees* for a more comprehensive discussion of this topic.

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