Accounting and reporting for contingencies—that is to say, potential gains and losses—is a topic that is not regularly on the front burner of finance and accounting professionals. It usually is covered in just a few pages in the standard intermediate accounting college textbook. Now, however, the increase in recession-induced merger and acquisition activity, the enhancement of executive exposure as a result of the Sarbanes-Oxley Act (SOX), and the business leadership focus on global risk management all point to the need for a renewed focus on accounting for contingencies. Also, related disclosures can shed valuable light on the potential of corporations to meet future reported earnings and cash flow goals.

Accounting Standards Codification® (ASC) 450, “Contingencies” (formerly Statement of Financial Accounting Standards No. 5 (SFAS No. 5), “Accounting for Contingencies”), applies to both gain and loss contingencies. With the exception of tax loss carryforwards, gain contingencies are not generally recognized because they could result in recognition of revenue before it is realized. In contrast, many types of loss contingencies are recognized. Principally, these include loss contingencies that result in liabilities, as well as those that involve asset impairments. ASC 450-20-25 (450, Contingencies; 20, Loss Contingencies; 25, Recognition) requires consideration of the likelihood that a contingency will be realized, as well as an assessment of whether the amount of the loss is reasonably estimable. Likelihood estimates range along a continuum from probable to reasonably possible to remote. In
general, loss contingencies are recorded when the likelihood of loss is probable and the amount is reasonably estimable. Both recorded loss contingencies and non-recorded loss contingencies are subject to disclosure.

International Accounting Standard (IAS) 37, 
Provisions, Contingent Liabilities and Contingent Assets, from the International Accounting Standards Board (IASB) is the principal international counterpart to ASC 450. Whereas ASC 450 focuses on the income statement (i.e., gains and losses), IAS 37 focuses on the balance sheet (i.e., recognition of an asset or liability/provision). Similar to the stipulations in ASC 450, unless realization of income is “virtually certain,” IAS 37 does not permit the recognition of contingent assets. For liabilities, IAS 37 requires consideration of the likelihood that “an outflow of resources embodying economic benefits will be required to settle the obligation,” as well as an assessment of whether the amount of the obligation is reasonably estimable.2

**Gain Contingencies**

To ensure that stakeholders are provided with transparent, conservative, and reliable financial statements, the Financial Accounting Standards Board (FASB) has formulated guidelines for corporations regarding the disclosure of potential, or “contingent,” gains and losses.3 In practice, entities follow a very conservative policy with regard to gain contingencies and generally only recognize tax-related uncertainties with a greater than 50% chance of being realized. Gain contingencies include potential gifts, donations, and bonuses; possible government refunds resulting from tax disputes; pending court cases in which a probable outcome is favorable; and tax carryforwards.

IAS 37 essentially treats gain contingencies the same way that U.S. Generally Accepted Accounting Principles (U.S. GAAP) treats them. It prohibits an entity from recognizing contingent assets and requires only brief disclosure when a future gain will probably be realized.4

**Loss Contingencies**

The principle of conservatism, which guides entities to refrain from disclosing gain contingencies, deems disclosure of loss contingencies not only permissible but necessary. A loss contingency is an existing condition, situation, or set of circumstances involving uncertainty as to possible loss to an entity that will ultimately be resolved when one or more future events occur or fail to occur.5 Generally, contingencies in this category are considered loss contingencies either because of a potential liability or a potential asset impairment. Examples of contingent liabilities include pending or threatened litigation, claims and assessments, and product warranties and defects. Those that involve asset impairments include collectability of receivables and threat of expropriation of assets.

**Treatment of Loss Contingencies**

As contingencies are by nature vague and difficult to estimate, their treatment differs based on the degree to which a loss is probable. In some cases, disclosure in the footnotes alone is adequate. In others, accrual and recognition on the face of the financial statements is required.

The first step to be taken in deciding whether and how to account for a contingency is to verify its existence.

Second, once it is known that a loss contingency exists, the entity must determine where on a continuum—from remote to reasonably possible to probable—the contingency lies.

Third, the entity must perform one of the following actions:

(a) If it is probable that a loss has been incurred at the date of the financial statements and the amount of loss can be reasonably estimated, the entity must accrue the loss and disclose related information. (Under this two-pronged test, the financial statement date is the cutoff point for assessing whether an event has occurred, resulting in the probability that an asset was impaired or a liability incurred. The purpose of the two conditions for accrual is to require recognition in the current period’s financial statements when losses associated with the current or prior period are reasonably estimable.)

(b) If it is not probable that a loss has been incurred or a probable loss cannot be reasonably estimated, the entity must disclose only related information.

(c) If there is only a remote possibility of loss, the
entity does not accrue or disclose the loss contingency (unless the contingency is with respect to guarantees).

One must keep in mind that the terms “probable” and “reasonably estimated” are difficult to quantify, and doing so is a subject of much debate within the FASB. The Board’s current position is documented in detail under ASC 450.

If disclosure is required, the entity must disclose in the notes to the financial statements:
◆ The nature of the accrual and
◆ The amount of the accrual if nondisclosure would result in financial statements that are misleading.

Under IAS 37, both recorded loss contingencies (termed “provisions”) and nonrecorded loss contingencies (referred to by the IAS as “contingent liabilities”) are subject to disclosure. In general, loss contingencies for which it is probable that resources will be required to satisfy the obligation must be recorded if the amount is reasonably estimable. Reporting of provisions under International Financial Reporting Standards (IFRS) is similar to the accrual and disclosure of loss contingencies under U.S. GAAP. The key difference is that IFRS prescribes accrual of provisions when the likelihood of the event occurring is more likely than not, but U.S. GAAP uses a higher threshold for accrual, namely, likely to occur. Furthermore, IAS 37 requires companies to disclose a roll-forward of the provision reported in the financial statements, but ASC 450 does not. As such, entities using IFRS are expected to report provisions more frequently than companies using U.S. GAAP (see Table 1).

Now we present four of the most prevalent forms of loss contingencies and discuss their treatment under both U.S. GAAP and IFRS:
◆ Litigation,
◆ Environmental liabilities,
◆ Guarantees, and
◆ Product warranties.

### Litigation, Claims, and Assessments
Microsoft, Inc., a corporation facing the most common type of loss contingency—litigation—integrated ASC 450 (when it was SFAS No. 5) over the course of several years. Its level of disclosure and need for accruals fluctuated as a civil lawsuit against it evolved. At the outset, when litigation was only pending, ASC 450 dictated that accrual and disclosure might be necessary, depending on two factors: the likelihood of an unfavorable outcome and the ability to estimate the loss. Once litigation began, Microsoft was required to comply with...
When leading European airline Air France-KLM faced litigation concerning antitrust laws, it was required by IFRS to comply with IAS 37 when presenting international financial statements.

In February 2006, the European Commission charged Air France-KLM and 27 other airlines with price fixing air shipping services. Subsequently, more than 40 purported class-action lawsuits seeking compensatory damages for prices paid since January 2000 were filed against air cargo operators. At the time, Air France-KLM reported that it was “unable to predict the outcome of these investigations requested by antitrust and civil litigation authorities, or the amount of penalties and compensatory damages which could be due.” Therefore, because of the lack of information, Air France-KLM simply disclosed the case in its 2006 financial statements without recording a provision for a loss.

The following year, when more civil suits were filed, the outcome remained difficult to predict. Air France-KLM disclosed the information and attempted to calm investors by stating that it did “intend to defend these cases vigorously.”

By 2008, however, it became apparent to Air France-KLM that a loss was likely to occur and that the amount of the loss was reasonably estimable. Therefore, the company reported a provision but (as permitted under IAS 37) did not disclose a dollar amount, stating, “the amount of the provision allocated...is not given, as such information is likely to harm the companies in their defense towards the competition authorities.”

Finally, in 2009 the fines were charged and paid, and Air France-KLM not only disclosed details of the case but also recorded a provision for the liability. The provision recorded in the books as of March 2010 “represents the best estimation of the risk...” (see Table 2).

### Environmental Liabilities

In September 2009, the U.S. Environmental Protection Agency (EPA) informed Energizer—the well-known manufacturer of batteries, portable lighting, and personal care products—that it had been identified as a “potentially responsible party” and might be required to share in the cost of environmental cleanup. Although litigation had just been initiated, Energizer immediately disclosed this information on its financial statements in compliance with the first of ASC 450’s two disclosure conditions. U.S. GAAP requires companies facing environmental litigation to disclose the loss contingency as soon as litigation has commenced or is probable.

The second condition for disclosure existed as well—that the probable outcome of such litigation would be unfavorable. Practically speaking, big corporations facing the EPA generally lose—to the extent that U.S. GAAP factors this reality into the guidelines. Taking aim at the EPA, Energizer noted on its financial statements that “liability...which mandate(s) cleanup is strict, meaning that liability may attach regardless of

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**Table 2: Air France-KLM, Inc.: Treatment of Loss Contingency under IAS 37**

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null
abused its dominant position and ordered Microsoft to pay $794 million—the heftiest fine ever ordered by the EC at the time—in addition to previous penalties, which included 120 days to divulge the server information and 90 days to produce a version of Windows without Windows Media Player. In its 2004 financials, Microsoft disclosed the lawsuit and included the dollar amount that it was fined, but it did not accrue any liability. Until 2004, Microsoft considered there to be at least a reasonable possibility that a liability had not been incurred. Therefore, no accrual was made because the amount of the loss could not, according to Microsoft, be reasonably estimated.

Although Microsoft strongly opposed the ruling and actually appealed it, the company paid the fine in full in July 2004. The following year, Microsoft supplied interested parties with even more information in its 2005 financial statement disclosures. The company included figures for both current and long-term liabilities related to the matter and not only disclosed the information but also accrued a liability. One may, therefore, presume that Microsoft considered it probable that a liability had been incurred at that point and was capable of reasonably estimating the loss.

Although Microsoft paid the fine, it did not fully comply with the information release requirements. In response, the EC fined Microsoft an additional $448 million—$2.39 million per day from December 16, 2005, to June 20, 2006—for its failure to comply. In the notes to the 2006 financial statements, Microsoft, having already experienced heavy fines, added the additional notice:

“There exists the possibility of adverse outcomes which we estimate could be up to $1.0 billion in aggregate beyond recorded amounts. Were an unfavorable final outcome to occur, there exists the possibility of a material adverse impact on the Company’s financial position and on the results of operations for the period in which the effect becomes reasonably estimable.”

In the following fiscal year, June 2007, Microsoft
presented the fines levied against it in even greater detail, indicating that it considered the contingent loss probable and reasonably estimable. Because Microsoft presented a lump-sum figure, however, it is unclear whether it accrued an appropriate amount or, rather, a minimum figure.

On September 17, 2007, Microsoft lost its appeal against the European Commission. The fine and the information release requirements were upheld. Furthermore, Microsoft was held responsible for 80% of the legal costs of the Commission. Finally, in February 2008, the European Commission fined Microsoft an additional $1.44 billion for failure to comply with the March 2004 antitrust decision. In response, Microsoft lodged an appeal, seeking to overturn that latest fine. The financial statements for the fiscal year ending June 2008 included this information.

Surprisingly, after accruing detailed figures regarding the European Commission lawsuit for years 2005 through 2008, Microsoft stopped accruing this contingent liability. For the fiscal year ended June 2009, Microsoft disclosed information only, stating “the outcome and range...is not reasonably estimable.” (See Table 3.)

In December 2009, Microsoft submitted proposals to address the competition law concerns, which were welcomed by the European Commission. The following year, the trade association withdrew its complaint that was the basis of the investigation. In June 2012, however, even after the allegations were withdrawn, the European General Court upheld the fine for noncompliance but reduced it slightly (by approximately $50 million) because of a claimed miscalculation. Microsoft has not announced yet whether they will again appeal the Court’s decision.

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Table 3: Microsoft, Inc.: Treatment of Loss Contingency under ASC 450 (formerly SFAS No. 5)

2 Ibid.
8 Ibid.
erate the Exposure Draft in the second quarter of 2009. At the time of the writing of this article, the FASB has taken no other action on this project.

Jonathan Schiff, CMA, Ph.D., is a professor of accounting at Fairleigh Dickinson University and is a member of the Bergen-Rockland-Meadowlands Chapter of IMA®. He can be reached at schiff@fdu.edu.

Allen Schiff, Ph.D., is a professor of accounting and director of the accounting and tax master’s degree programs at Fordham University’s Graduate School of Business.

Hannah Rozen, Ph.D., is assistant professor of accounting at Fairleigh Dickinson University.

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ENDNOTES
3 Financial Accounting Standards Board, Accounting Standards Codification 450-30-25. [Predecessor literature: SFAS No. 5, paragraph 17(a), Norwalk, Conn., 1975.]
4 International Accounting Standards Board, IAS 37, paragraph 31, 34, 2009.
5 International Accounting Standards Board, IAS 37, Provisions, Contingent Liabilities and Contingent Assets, (paragraph 10 (b), 2009.
6 All company information was taken from each firm’s annual reports (10-K).
7 Financial Accounting Standards Board, Accounting Standards Codification 450-20-55 [Predecessor literature: SFAS No. 5, paragraph 33(b), Norwalk, Conn., 1975.]
8 Financial Accounting Standards Board, Accounting Standards Codification 450-20-60 [Predecessor literature: SFAS No. 5, paragraph 12, Norwalk, Conn., 1975.]