A Roadmap to Accounting for Contingencies and Loss Recoveries

2019
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Acknowledgments

Susan Fennedy and Dennis Howell supervised the overall preparation of this Roadmap and extend their appreciation to Kelsey Barclay, whose significant contributions made the inaugural edition of this Roadmap possible.

They would also like to acknowledge the members of our production group for their contributions — especially Michael Lorenzo, the production group leader; Peter McLaughlin, who made the “accounting-speak” understandable; Sandy Cluzet and Geri Driscoll, who copyedited the document; and Teri Asarito, David Frangione, and Lora Spickler-Alot, who designed the Roadmap’s layout and graphics. They also wish to thank Deloitte Audit & Assurance Services professionals Laxmi Pabbaraju and Inderjeet Singh for their high-quality research and drafting; and Deloitte’s U.S. Audit Services, particularly Meredith Lincoln.
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Preface

November 2019

To the clients, friends, and people of Deloitte:

We are pleased to present the inaugural edition of A Roadmap to Accounting for Contingencies and Loss Recoveries. This Roadmap provides Deloitte's insights into and interpretations of the accounting guidance in ASC 450 on loss contingencies, gain contingencies, and loss recoveries. The goal of this publication is to assist entities in understanding and applying ASC 450. Although this guidance has not changed significantly for decades, the application of the existing framework remains challenging at times because a significant amount of judgment may be required, including the likely need for legal interpretations.

In addition to summarizing the accounting framework in ASC 450 and providing an in-depth discussion of key concepts, the Roadmap includes examples to illustrate how these concepts may be applied in practice. This publication reflects guidance that is effective for public business entities for annual reporting periods beginning on or after January 1, 2019, including ASC 606 and ASC 842 related to revenue and leases, respectively. We have specifically highlighted sections of the Roadmap that will be affected by an entity's adoption of ASU 2016-13, which addresses credit losses.

Note that this Roadmap is not a substitute for the exercise of professional judgment, which is often essential to applying the requirements of ASC 450. It is also not a substitute for consulting with Deloitte professionals on complex accounting questions and transactions.

Subscribers to the Deloitte Accounting Research Tool (DART) may access any interim updates to this publication by selecting the document from the “Roadmaps” tab on DART's home page. If a “Summary of Changes Since Issuance” displays, subscribers can view those changes by clicking the related links or by opening the “active” version of the Roadmap.

We hope that you find this publication a valuable resource when considering the accounting guidance on loss contingencies, gain contingencies, and loss recoveries.

Sincerely,

Deloitte & Touche LLP

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1 For the full titles of standards, topics, and regulations used in this publication, see Appendix B. For a list of abbreviations used in this publication, see Appendix C.
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Chapter 1 — Overview

1.1 Introduction
This Roadmap discusses the application of the guidance in ASC 450 on contingencies and loss recoveries. The accounting for contingencies is derived from FASB Statement 5, which the FASB issued in 1975 and which was codified in ASC 450. That guidance has remained substantially unchanged. Questions about the guidance’s scope and how to apply its recognition, measurement, and disclosure requirements continue to arise given the inherent uncertainty related to the accounting for contingencies and loss recoveries.

1.2 History of Contingencies Guidance
FASB Statement 5 established an accounting and reporting framework for loss contingencies and carried forward the conclusions of ARB 50 with respect to gain contingencies and other disclosures. In 1976, the FASB clarified the use of a range as part of the estimation of a contingent liability in FIN 14.

In July 2010, the FASB issued a proposed ASU that would have amended the ASC 450 disclosure requirements for loss contingencies in response to concerns raised by investors and users of financial reporting that disclosures about loss contingencies under the existing guidance in ASC 450 did not provide adequate and timely information to assist them in assessing the likelihood, timing, and amount of future cash outflows associated with loss contingencies. In particular, the proposed ASU stated that “[d]isclosure of asserted but remote loss contingencies may be necessary, due to their nature, potential magnitude, or potential timing (if known) to inform users about the entity’s vulnerability to a potential severe impact.” Further, the proposed ASU stated, “[t]his proposed change in the disclosure threshold would expand the population of loss contingencies that are required to be disclosed to achieve more timely disclosure of remote loss contingencies with a potentially severe impact.” The FASB did not proceed with finalizing the proposed ASU after consideration of comments received but rather directed the FASB staff to work with the staffs of the SEC and the PCAOB to understand their efforts in addressing investors’ concerns about the disclosure of certain loss contingencies through increased focus on compliance with existing rules. In July 2012, the Board ultimately decided to remove the project on disclosures of certain loss contingencies from its technical agenda. Given the concerns expressed by investors and users, compliance with the disclosure requirements of ASC 450 historically has been and continues to be an area of focus by the SEC staff in its review of a registrant’s periodic filings.
Contingent liabilities are liabilities for which the possible loss outcome is unknown or uncertain, such as from pending litigation. The likelihood that a liability has been incurred ranges from “remote” to “reasonably possible” to “probable.” The ASC master glossary's definitions of these terms provide no quantitative thresholds, and accordingly, entities need to exercise judgment when applying the terms.

A gain contingency also includes characteristics of uncertainty, differing from a loss contingency in that the resolution of a gain contingency could possibly result in a gain. The recognition threshold for a gain contingency is substantially higher than that of a loss contingency.

Chapter 2 provides an overview of the scoping, recognition, measurement, and disclosure requirements for loss contingencies, along with certain interpretive guidance on accounting for loss contingencies. Chapter 3 provides similar information in the context of gain contingencies. See Chapter 4 for guidance on how to apply the loss recovery model to a recognized loss and possible recovery proceeds.
Because the nature of a contingency is to evaluate the likelihood of occurrence or nonoccurrence of a future event that may confirm a previous loss, impairment of an asset, or incurrence of a liability, contingencies may be at risk of being overlooked for recognition or disclosure. Disclosure of certain contingencies, even those that are not recognized, is important to enable users of the financial statements to understand an entity’s risks and how they could potentially affect the financial statements.

Management should have processes in place to capture, evaluate, and document the recognition, measurement, and disclosure of contingencies. Entities should thoroughly document key judgments, the completeness and the accuracy of information used in reaching those judgments (including contradictory information, if any), and their support for any significant assumptions. In addition, when management engages a specialist or expert, management retains overall responsibility with respect to the oversight of the specialist’s or expert’s activities and for the resulting product, including ownership of the amounts determined by the engaged specialist or expert as well as the design, implementation, and maintenance of internal control over financial reporting (ICFR).

Throughout this Roadmap, “date of the financial statements” means the end of the most recent accounting period for which financial statements are being presented (i.e., December 31, 20X9, for an entity with a calendar year-end that presents annual comparative financial statements for periods ended December 31, 20X8, and 20X9).
Chapter 2 — Loss Contingencies and Commitments

2.1 Overview

ASC 450 defines a loss contingency as “[a]n 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.” Resolution of uncertainty in the context of a loss contingency may confirm the loss, the impairment of an asset, or the incurrence of a liability. This chapter provides an overview of the scoping, recognition, measurement, and disclosure requirements for loss contingencies, along with certain interpretive guidance on accounting for them.

Contingent liabilities are liabilities for which the possible loss outcome is unknown or uncertain, such as pending or threatened litigation, actual or possible claims, or product defects. Uncertainty is inherent in all loss contingencies. ASC 450-20 uses “probable,” “reasonably possible,” and “remote” to determine the likelihood of the future event that will confirm a loss, an impairment of an asset, or the incurrence of a liability. No quantitative characteristics are provided in the codified definitions, and accordingly, entities need to exercise judgement when applying the terms.

Accrual of a loss contingency is required when (1) it is probable that a loss has been incurred and (2) the amount can be reasonably estimated. An entity must determine the probability of the uncertain event and demonstrate its ability to reasonably estimate the loss from it to accrue a loss contingency. Loss contingencies that do not meet both of these criteria for recognition may need to be disclosed in the financial statements.

Typically, accounting literature uses either a probability-based model or a fair value model when dealing with uncertainty related to losses. The probability-based recognition guidance in ASC 450-20 differs from that in other Codification topics that use a fair value objective to measure liabilities. Measurement of a liability at fair value requires consideration of events whose occurrence is less than probable, since “fair value is not an estimate of the ultimate settlement amount or the present value of an estimate of the ultimate settlement amount.” Therefore, recognition of the fair value of an obligation results in recognition of some obligations for which the likelihood of future settlement, although more than zero, is less than probable from a loss contingencies perspective.

2.1.1 Relationship Between Recognized Loss Contingencies and Reserves

As indicated in ASC 450-20-05-8 and 05-9, accrual of a loss contingency does not create or set aside funds to lessen the possible financial impact of a loss. ASC 450-20-05-8 states, in part:

Confusion exists between accounting accruals (sometimes referred to as accounting reserves) and the reserving or setting aside of specific assets to be used for a particular purpose or contingency. Accounting accruals are simply a method of allocating costs among accounting periods and have no effect on an entity's cash flow. Those accruals in no way protect the assets available to replace or repair uninsured property that
may be lost or damaged, or to satisfy claims that are not covered by insurance, or, in the case of insurance entities, to satisfy the claims of insured parties. Accrual, in and of itself, provides no financial protection that is not available in the absence of accrual.

ASC 450-20-05-9 states that “[a]n entity may choose to maintain or have access to sufficient liquid assets to replace or repair lost or damaged property or to pay claims in case a loss occurs. Alternatively, it may transfer the risk to others by purchasing insurance.” The guidance in ASC 450-20 does not “affect the fundamental business economics of that decision.” That financial decision is made by the entity’s management, and “the presence or absence of an accrued credit balance on the balance sheet will have no effect on the consequences of that decision. Insurance or reinsurance reduces or eliminates risks and the inherent earnings fluctuations that accompany risks. Unlike insurance and reinsurance, the use of accounting reserves does not reduce or eliminate risk. The use of accounting reserves is not an alternative to insurance and reinsurance in protecting against risk. Earnings fluctuations are inherent in risk retention, and they are reported as they occur.” Further, in a manner consistent with ASC 450-20-50-1, which requires entities to disclose the nature of recognized accruals, entities should refrain from using the term “reserves” when referring to the accrual of loss contingency.

### 2.2 Loss Contingency Scope

<table>
<thead>
<tr>
<th>ASC 450-20</th>
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<tbody>
<tr>
<td><strong>15-2</strong> The following transactions are excluded from the scope of this Subtopic because they are addressed elsewhere in the Codification:</td>
</tr>
<tr>
<td>a. Stock issued to employees, which is discussed in Topic 718.</td>
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<tr>
<td>b. Employment-related costs, including deferred compensation contracts, which are discussed in Topics 710, 712, and 715. However, certain postemployment benefits are included in the scope of this Subtopic through application of paragraphs 712-10-25-4 through 25-5.</td>
</tr>
<tr>
<td>c. Uncertainty in income taxes, which is discussed in Section 740-10-25.</td>
</tr>
<tr>
<td>d. Accounting and reporting by insurance entities, which is discussed in Topic 944.</td>
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<tr>
<th>Pending Content (Transition Guidance: ASC 326-10-65-1)</th>
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<tbody>
<tr>
<td><strong>15-2</strong> The following transactions are excluded from the scope of this Subtopic because they are addressed elsewhere in the Codification: . . .</td>
</tr>
<tr>
<td>e. Measurement of credit losses for instruments within the scope of Topic 326 on measurement of credit losses.</td>
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All loss contingencies should be evaluated under ASC 450-20 unless the contingency is within the scope of another source of authoritative literature that specifically prescribes an alternate accounting model. The table below contains a nonexhaustive list of examples of contingencies or uncertainties that are within the scope of other authoritative literature.
| ASC 270 | “[C]ontingencies and other uncertainties that could be expected to affect the fairness of presentation of financial data at an interim date.” (ASC 450-10-60-1) |
| ASC 275 | “[D]isclosure of certain risks and uncertainties that stem from the nature of an entity’s operations and from significant concentrations in certain aspects of an entity’s operations, many of which are noninsured or underinsured risks.” (ASC 450-20-60-1) |
| ASC 340-30 | Contingencies related to “insurance and reinsurance contracts that do not transfer insurance risk.” (ASC 450-10-60) |
| ASC 326 | • Collectibility of receivables or a loan portfolio.  
• Measurement of credit losses. |
| ASC 330-10 | • “[I]nterim valuations and other factors.” (ASC 450-20-60-4)  
• “[L]osses that are expected to arise from firm, uncancelable, and unhedged commitments for the future purchase of inventory.” (ASC 450-20-60-5) |
| ASC 405-30 | “[A]ssessments by state guaranty funds and workers’ compensation second-injury funds and other assessments related to insurance activities, including insurance activities of an entity that self-insures.” (ASC 450-20-60-6) |
| ASC 410-20 | “[C]ontingencies associated with the retirement of a tangible long-lived asset” resulting “from the acquisition, construction, or development and/or the normal operation of a long-lived asset.” (ASC 450-20-60-7) |
| ASC 410-30 | Environmental remediation liabilities that are otherwise not within the scope of ASC 410-20. |
| ASC 460-10 | “[C]ontingencies related to [p]roduct warranties and product defects,” “guarantees of indebtedness of others,” and “obligations of commercial banks under financial standby letters of credit.” (ASC 450-20-60-9 through 60-11) |
| ASC 470-60 | “[C]ontingent payments of a troubled debt restructuring.” (ASC 450-20-60-12) |
| ASC 606-10 | For contracts with customers, estimating and constraining variable consideration (e.g., a sale with a right of return) included in the transaction price. |
| ASC 610-20 | For contracts with counterparties that are not customers, estimating and constraining variable consideration included in the transaction price. |
| ASC 610-30 | When the amount of monetary assets to be received is uncertain in an involuntary conversion (destruction or damage of a nonmonetary asset). |
| ASC 710, 712, 715, and 718 | Contingencies and uncertainties related to stock issued to employees, employment-related costs, including deferred compensation contracts and withdrawal from multiemployer plans. However, certain postemployment benefits are included within the scope of ASC 450. |
### Chapter 2 — Loss Contingencies and Commitments

| ASC 720-20 | • “Contingencies associated with a multiple-year retrospectively rated insurance contract accounted for as insurance.” (ASC 450-10-60-5)  
|            | • “Contingencies related to an insurance contract or reinsurance contract that does not, despite its form, provide for indemnification of the insured or the ceding company by the insurer or reinsurer against loss or liability.” (ASC 450-20-60) |
| ASC 740-10 | Income tax uncertainty. |
| ASC 805-10 | • “[C]ontingent obligations for contractual termination benefits and curtailment losses under employee benefit plans that will be triggered by the consummation of the business combination.” (ASC 450-10-60-7)  
|            | • Contingencies recorded at fair value, if determinable. |
| ASC 840    | “Classification effects of a provision in a lease that requires lessee indemnifications for environmental contamination caused by the lessee during its use of the property.” (ASC 450-20-60-16) |
| ASC 842    | “Variable lease payments.” (ASC 450-20-60-15) |
| ASC 860-10 | “[C]ontingencies related to agreements to repurchase receivables (or to repurchase the related property) that have been sold or otherwise assigned.” (ASC 450-20-60-17) |
| ASC 944-20 and ASC 944-40 | • “Contingencies associated with multiple-year retrospectively rated contracts. (ASC 450-10-60-5)  
|            | • “Contingencies related to the risk of loss that is assumed by a property and casualty insurance entity or reinsurance entity when it issues an insurance policy covering risk of loss from catastrophes.” (ASC 450-20-60-19) |
| ASC 954-450| “[C]ontingencies related to malpractice claims.” (ASC 450-20-60-21) |
Certain scoping topics where questions may arise are addressed further below.

2.2.1 Firmly Committed Executory Contracts

Although the ASC master glossary does not define “executory contract,” U.S. GAAP and IFRS® Standards broadly define the term:

• Although never finalized and ultimately removed from the EITF's agenda, EITF Issue 03-17 refers to an executory contract as “a contract that remains wholly unperformed or for which there remains something to be done by either or both parties of the contract.”

• IAS 37 refers to an executory contract as a contract “under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent.”

The ASC master glossary defines a firm purchase commitment as “an agreement with an unrelated party, binding on both parties and usually legally enforceable,” that is both (1) specific in “all significant terms, including the price and timing of the transaction,” and (2) “includes a disincentive for nonperformance that is sufficiently large to make performance probable.” Disincentives for nonperformance may be, for example, in the form of (1) a fixed payment requirement for each period under the agreement regardless of whether the purchaser takes delivery or (2) the inability of a purchaser to change the contractual delivery and payment terms with a supplier without a penalty payment for nonperformance.

At the inception of a firmly committed executory contract, both parties to the contract expect to receive benefits from the contract that are equal to or greater than the costs to be incurred under the contract. However, during the term of the contract, the fair value of the remaining contractual rights may unexpectedly decline below the remaining costs to be incurred, resulting in a firmly committed executory “loss contract.”

When determining whether to recognize a contingent liability for such a loss contract, entities should first consider the applicability of any industry- and transaction-specific guidance. Under U.S. GAAP, the following ASC topics provide guidance related to firmly committed executory contracts:

• A firm purchase commitment for goods or inventory under ASC 330.

• Construction or production-type contracts within the scope of ASC 605-35 (see Section 12.5 of Deloitte’s A Roadmap to Applying the New Revenue Recognition Standard (“Revenue Roadmap”) for a discussion of onerous performance obligations).

• Certain executory contracts subject to ASC 420 related to exit or disposal activities.

• An insurance contract with a premium deficiency subject to ASC 944-60.

• Certain derivative contracts within the scope of ASC 815.

• Operating leases subject to ASC 840-20.

The EITF discussed loss recognition for all other firmly committed executory contracts (i.e., those contracts not otherwise within the scope of authoritative literature that provide recognition and measurement guidance for losses in accordance with firmly committed executory arrangements) from the perspective of the buyer in EITF Issue 99-14 and from the perspective of the seller in EITF Issue 00-26. However, the EITF was unable to reach a consensus on these issues because of their broad scope and recommended that the FASB add a project on executory contracts to its agenda. Currently, there is no authoritative accounting guidance, other than that referred to above, that would support the recognition of a contingent liability when the fair value of remaining contractual rights under a firmly committed executory contract declines below the remaining costs to be incurred.
While the EITF did not provide authoritative guidance on the recognition of a liability for a loss contract, the SEC staff has stated that it generally would not be appropriate for a lessee to accrue a liability for losses associated with an operating lease agreement until the lessee no longer benefits from the use of the property subject to the lease. While the accrual of a liability is no longer relevant after the adoption of ASC 842, the ASC 840 guidance concepts are often applied by analogy to other types of executory contracts. We generally believe that it is inappropriate to accrue for a loss in accordance with a firmly committed executory contract unless there is specific authoritative literature to the contrary.

Regardless of whether an entity has recognized a liability related to a firmly committed executory contract, the entity should consider the need for disclosure of the arrangement in the financial statements to prevent the financial statements from being misleading. In addition, SEC registrants should consider whether commitments related to executory contracts should be included in their contractual commitments tables (as stipulated by SEC Regulation S-K, Item 303(a)(5)) or, in accordance with SEC Regulation S-K, Item 303(a)(3)(ii), within MD&A as a known “trend, event, or uncertainty” that may affect future earnings or other measures of performance. See Section 2.8.4 for a discussion of firmly committed executory contract disclosure requirements.

2.2.2 Application of ASC 450 to Employee Benefit Arrangements

Compensation to executives and employees in addition to base salary or wages can take many forms, including (1) share-based payment arrangements, (2) deferred compensation or bonus plans, and (3) postemployment benefit, postretirement benefit, and special termination or early retirement plans. The specific accounting requirements vary depending on the nature of the compensation arrangement. ASC 450 should be applied to certain compensation or benefit plans that are not specifically addressed by other authoritative accounting literature (e.g., certain cash bonus arrangements).

In addition, certain compensation arrangements are accounted for in accordance with ASC 710 and not ASC 450 when specific conditions are met. For instance, certain postemployment benefits within the scope of ASC 712 that meet the following conditions as defined in ASC 710-10-25-1 are accounted for in accordance with ASC 710-10:

- The employer’s obligation to provide an employee with postemployment compensation is attributed to the employee’s services already rendered.
- “The obligation relates to rights that vest or accumulate.”
- “Payment of the compensation is probable.”
- “The amount can be reasonably estimated.”

However, ASC 712-10-25-5 requires that certain postemployment benefits that do not meet the above conditions be accounted for in accordance with ASC 450-20-25-2 when the loss is probable and can be reasonably estimated.

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1 See ASC 712-10-15-3 and 15-4 for a discussion of transactions that could be subject to the scope of ASC 710.
Example 2-1

Postemployment Benefits

Two weeks of workers’ compensation benefits may be available to employees in the event of a disability. Additional years of service do not result in an increased workers’ compensation benefit. This type of nonvesting and nonaccumulating postemployment benefit plan is accounted for in accordance with ASC 450-20-25-2. Upon the occurrence of the event that gives rise to the liability (i.e., the injury that entitles the employee to disability benefits), the associated estimated stream of future cash flows is accrued. In contrast, ASC 712-10-25-4 requires postemployment benefits that vest or accumulate to be accrued as service is performed.

See Section 2.3.2.7 for a discussion of the recognition of liabilities related to annual bonus plans.

2.2.3 Collectibility of Receivables

2.2.3.1 Before the Adoption of ASU 2016-13

ASC 450-20 provides the basic guidance for recognition of impairment losses for all receivables (except those receivables, such as debt securities, that are specifically addressed by other topics). Further, ASC 310-10-35-2 observes that ASC 310-10 “provides more specific guidance on measurement and disclosure for a subset of the population of loans. That subset consists of loans that are identified for evaluation and that are individually deemed to be impaired (because it is probable that the creditor will be unable to collect all the contractual interest and principal payments as scheduled in the loan agreement). It also includes all loans that are restructured in a troubled debt restructuring involving a modification of terms, except for those loans that are excluded from the scope of this guidance, as discussed in paragraph 310-10-35-13(b) through (d).” The criteria for recognition of a loss from an uncollectible receivable are similar under ASC 310-10-35-8 through 35-11 and ASC 450-20-25-2 in that a loss is recognized when both of the following conditions are met: (1) it is probable that an entity “will be unable to collect all amounts due according to the contractual terms of the receivable” and (2) uncollectible amounts “can be reasonably estimated.”

2.2.3.2 After the Adoption of ASU 2016-13

In June 2016, the FASB issued ASU 2016-13, which amends the guidance on impairment of financial instruments. The ASU adds to U.S. GAAP an impairment model, known as the current expected credit loss (CECL) model, that is based on expected losses rather than incurred losses. The incurred losses model delayed recognition until it was probable a loss had been incurred. Under the CECL model, receivables that are expected to be uncollectible but do not yet meet the probable threshold will result in recognition of losses. Accordingly, credit losses resulting from an entity’s inability to collect receivables from customers do not meet the recognition criteria outlined in ASC 450-20-25-2 and are therefore exempt from the scope of ASC 450-20. The ASU is effective for public business entities (PBEs) that meet the definition of an SEC filer, excluding entities that meet the SEC’s definition of smaller reporting companies, for fiscal years beginning after December 15, 2019, including interim periods therein. For all other entities, the ASU is effective for fiscal years beginning after December 15, 2022, including interim periods therein.²

² At its October 16, 2019, meeting, the FASB directed the drafting of the final ASU for vote by written ballot that amends the effective dates included in ASU 2016-13 to those mentioned in this paragraph.
2.2.4 Differentiating Between Contingent Liabilities and Contractual or Legal Liabilities

Contingent liabilities involve uncertainty about whether a loss has been incurred. The key when an entity is distinguishing between a contingent liability that is within the scope of ASC 450-20 and a contractual or legal liability is for the entity to determine whether there is uncertainty regarding whether the entity is obligated to pay another party. Contractual or legal liabilities are debts or obligations between two or more parties that are typically settled by the transfer of cash, assets, or services, and there is generally little to no uncertainty about the likelihood of occurrence of the future settlement.

Paragraph 36 of FASB Concepts Statement 6 states that a “liability has three essential characteristics: (a) it embodies a present duty or responsibility to one or more other entities that entails settlement by probable future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand, (b) the duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice, and (c) the transaction or other event obligating the entity has already happened.”

The probability of payment is irrelevant if settlement of the liability is required by law or by contract. That is, other than deferred revenues, liabilities established by law or contract should be recorded at their stated amounts unless the guidance in U.S. GAAP requires otherwise. Section 8.8 of Deloitte’s Revenue Roadmap specifically addresses the accounting for breakage in situations in which the customer is not expected to exercise all of its contractual rights to goods or services in a revenue contract.

If an entity is required by current laws, regulations, or contracts to make a future payment associated with an event that has already occurred, that event imposes a present duty upon the entity. An entity’s uncertainty about whether an obligee will require performance does not allow the entity to choose to avoid the future sacrifice; nor does the uncertainty relieve the entity of the obligation.

When the obligating event has occurred, the probability of payment is not relevant in the determination of whether a contractual or legal obligation is a liability or a loss contingency. That is, when the obligating event has occurred, the entity has incurred a liability; accordingly, there is no contingency. This is supported by analogy to paragraph B21 in the Background Information and Basis for Conclusions of FIN 48, which states that the “Board also considered the guidance in paragraphs 26 and 36 of Concepts Statement 6 on the characteristics of an asset and liability. The Board noted that consideration of examination risk is not consistent with the characteristics of an asset or a liability.”

In the context of uncertainty regarding income taxes, “examination risk” represents the risk that a taxing authority would examine a particular tax position. In the Background Information and Basis for Conclusions of FIN 48, the Board rejected the idea that accounts payable, for example, should be recorded on the basis of the amount that an entity would ultimately pay if the creditor filed suit to collect the liability.

This conclusion is further supported by analogy to ASC 410-20-25-15, which states that an “unambiguous requirement that gives rise to an asset retirement obligation coupled with a low likelihood of required performance still requires recognition of a liability.”

In addition, a liability is not an unasserted claim or assessment under ASC 450-20 if the satisfaction of the liability is required by law or by contract. The existence of the law or the contract asserts the claim. This conclusion is supported by analogy to paragraph B20 in the Background Information and Basis for Conclusions of FIN 48, which states that the “Board considered the guidance on unasserted claims in paragraph 38 of Statement 5 [codified in ASC 450]. The Board does not believe that guidance is
applicable to tax positions because a tax return is generally required to be filed based on the provisions of tax law."

Once recognized, a contractual or legal liability that is not deferred revenue (i.e., a contract liability under ASC 606) should be derecognized only once the conditions for liability derecognition in ASC 405-20-40-1 have been met.

<table>
<thead>
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<th>ASC 405-20</th>
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| **40-1** A debtor shall derecognize a liability if and only if it has been extinguished. A liability has been extinguished if either of the following conditions is met:

a. The debtor pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes the following:
   1. Delivery of cash
   2. Delivery of other financial assets
   3. Delivery of goods or services
   4. Reacquisition by the debtor of its outstanding debt securities whether the securities are cancelled or held as so-called treasury bonds.

b. The debtor is legally released from being the primary obligor under the liability, either judicially or by the creditor. For purposes of applying this Subtopic, a sale and related assumption effectively accomplish a legal release if nonrecourse debt (such as certain mortgage loans) is assumed by a third party in conjunction with the sale of an asset that serves as sole collateral for that debt.

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<th>Pending Content (Transition Guidance: ASC 405-20-65-1)</th>
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| **40-1** Unless addressed by other guidance (for example, paragraphs 405-20-40-3 through 40-4 or paragraphs 606-10-55-46 through 55-49), a debtor shall derecognize a liability if and only if it has been extinguished. A liability has been extinguished if either of the following conditions is met:

a. The debtor pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes the following:
   1. Delivery of cash
   2. Delivery of other financial assets
   3. Delivery of goods or services
   4. Reacquisition by the debtor of its outstanding debt securities whether the securities are cancelled or held as so-called treasury bonds.

b. The debtor is legally released from being the primary obligor under the liability, either judicially or by the creditor. For purposes of applying this Subtopic, a sale and related assumption effectively accomplish a legal release if nonrecourse debt (such as certain mortgage loans) is assumed by a third party in conjunction with the sale of an asset that serves as sole collateral for that debt.

A contractual or legal liability is subject to the above liability derecognition guidance regardless of whether an entity believes that on the basis of a probability assessment, such a liability can be settled for less than the stated legal obligation.

Examples 2-2 and 2-3 below illustrate the accounting for a liability for which payment is required by law or contract, even though detection and settlement may be uncertain.
Example 2-2

Probability Assessment Related to Sales Tax Liability for Which Payment Is Required by Law, but Detection and Settlement Are Uncertain

Entity Z has sold goods in Jurisdiction Y for 15 years and continues to sell them. By law, those sales would be subject to sales tax in Y if Z had nexus there. To assess whether Z has sales tax nexus in Y and should record a sales tax liability, Z diligently reviews prior-period sales records and interviews sales managers. Through this analysis, Z determines and documents that sales tax nexus in Y has existed for the past 15 years. Therefore, Z’s products have always been taxable and subject to sales tax collection; however, Z has never collected sales tax or filed sales tax returns in Y. Entity Z has never been audited or contacted regarding a sales tax audit by taxing authorities in Y. Entity Z believes that the risk of detection by the taxing authorities in Y is low. However, if the taxing authorities in Y were presented with all the facts about Z’s activities, Z believes that it is probable that Y would assert that Z is liable for uncollected sales taxes and demand payment. Entity Z believes that Y would settle for an amount less than the full liability.

Entity Z should record a sales tax liability on the basis of its sales activities for the full amount that it is legally obligated to remit to the taxing authorities in Y. The sale of goods triggers the obligation to make the related sales tax payments. In measuring its sales tax liability, Z may not consider that the risk of detection by the taxing authorities in Y is low. Further, Z must assume that the taxing authorities in Y have all the relevant facts about Z’s operations in Y. Interest and penalties should also be included in the estimate of the liability if the imposition of interest and penalties is required by law.

Note that some state taxing authorities may have a widely understood administrative practice and precedent in which, in the event of an examination and in the absence of a voluntary disclosure agreement, the taxing authority would look back no more than a certain number of years to determine the amount of sales tax deficiency due. Alternatively, a statute of limitations may exist. Thus, Z should evaluate whether the taxing authorities in Y will assess Z back to the first year of taxable sales (i.e., the full 15 years) or whether the liability will be limited by a statute of limitations or Y’s administrative policies. In performing this evaluation, Z must use judgment to determine what constitutes “widely understood.” If Z asserts that an administrative practice and precedent is widely understood, Z should document the basis of that assertion as well as any evidence to support it. Such evidence may include reliable knowledge of the taxing authority’s past dealings with Z on the same tax matter when the facts and circumstances were similar. An assessment of what Z believes it could negotiate as a settlement with the taxing authority would generally not represent a “widely understood” administrative practice and precedent.

Similarly, Z should also adjust its liability to the extent that its customers have paid use tax on any portion of Z’s sales during any part of the look-back period. However, because the obligating event is the sale of goods, Z should not record a sales tax liability for future sales until those sales actually occur.

Entity Z should regularly assess its sales tax obligations in the jurisdictions in which it conducts business. If Z has any uncertainty about those obligations, Z might need to obtain legal opinions. Sales tax liabilities should be adjusted upward as sales are made and should be adjusted downward only when the liability is paid or otherwise extinguished. (Note that sales taxes are not within the scope of ASC 740.)
Example 2-3

Royalty Liability for Which Payment Is Required by Contract, but Detection and Settlement Are Uncertain

Company Y manufactures technical equipment and has a contractual obligation to pay, on the basis of sales volume, royalties to various patent holders. The amount of royalties paid each period is calculated by Y. In accordance with this obligation, patent holders have the right to audit Y's sales volume, but they have rarely exercised this right.

Company Y should record a royalty liability for the full amount that it is contractually obligated to pay according to the royalty agreements. The contracts require Y to make royalty payments on the basis of sales volume. Therefore, Y is under an obligation to the patent holders as the equipment is sold (i.e., Y has a present duty to the patent holders). The liability should be adjusted upward as sales are made and should be adjusted downward only when the liability is paid or otherwise extinguished in accordance with ASC 405-20-40-1.

In a scenario whereby a patent holder cannot be located, Y should consider whether liability derecognition has occurred once the escheat laws of the relevant jurisdiction are complied with and the obligation no longer exists. Company Y's uncertainty about whether a patent holder will audit the sales volume does not allow it to avoid future payment. Finally, Y should not record a royalty liability for future sales until those sales actually occur.

Connecting the Dots

There may be uncertainty about whether an entity is subject to or within the scope of a current law, regulation, or contract owing to ambiguity about the interpretation of the current law, regulation, or contract. Examples include uncertainties related to a tax based on gross receipts, revenue, or capital. In these circumstances, an entity should evaluate the uncertainty in accordance with the flowchart below.

Is there uncertainty related to whether the entity is subject to a law, regulation, or contract? Yes No

Is it probable (as defined by ASC 450-20) that the entity is subject to the law, regulation, or contract? Yes No

Account for the liability in accordance with the law, regulation, or contract. Account for the law, regulation, or contract in accordance with ASC 450-20. Continue to evaluate additional or new evidence that may indicate that it is probable that the entity is subject to the law, regulation, or contract. Until it becomes probable that the entity is subject to the law, regulation, or contract, account for the uncertainty in accordance with ASC 450-20.

Example 2-4 below illustrates the analysis an entity would perform in determining whether it has a liability that is subject to contract, law, or regulation, or whether the uncertainty should instead be accounted for in accordance with ASC 450-20.
Example 2-4

Determining Whether an Entity Is Subject to a Disputed Contractual Executory Agreement

Company B manufactures and sells glass containers for beverages and food. On January 6, B enters into a contractual executory agreement with Vendor T to develop an inventory management system, customized to B’s specific needs. It is estimated that the project will take 18 months and will cost $1.5 million, payable in equal quarterly installments or $250,000 for services provided to date. The agreement can be terminated only for cause and includes no termination penalty; however, B will be liable for $1.5 million unless T breaches the contract.

Six months into the system development, despite assurance provided by T, B realizes that the system T is developing will not be able to perform certain functions B feels are essential to a new glass bottle manufacturing and distribution inventory management system. On September 1, before the third quarterly installment is due to T for services performed to date, B’s legal counsel sends a breach of contract notice to T, notifying it that B is not receiving the inventory management system it had contracted for. Vendor T ceases performing all services upon receipt of the breach of contract notice on September 1.

As of the third quarter ended September 30, B has terminated the executory contract with T by providing a breach of contract notice, and T has ceased performing services. Therefore, B determines that it is not contractually obligated for any remaining unpaid amounts in accordance with the contract for unperformed services. Accordingly, B compensates T for third-quarter services received through September 1. Company B will separately assess in accordance with ASC 450-20 whether a contingent liability exists for amounts that would have otherwise been due (either through September 30 or the end of the 18-month contract term) had the contract not been terminated. If B determines that T is disputing the executory contract termination, B should determine whether the contingent liability recognition criteria have been met in accordance with ASC 450-20-25 and provide adequate disclosures related to the contract and dispute.

2.2.5 Elements of a Litigation Settlement

There may be litigation settlements in which the settlement agreement includes past obligations and disputes and modifies the ongoing contractual terms of the business relationship. When accounting for a litigation settlement that also includes a separate element (such as a revenue element) and bifurcating the elements, an entity should consider a speech made by Eric West, associate chief accountant in the SEC’s Office of the Chief Accountant, at the 2007 AICPA National Conference on Current SEC and PCAOB Developments. We consider the interpretive guidance shared by Mr. West to be relevant and useful to private companies in addition to SEC registrants. Mr. West summarized a settlement arrangement as follows:

[A] company pays cash and conveys licenses to a plaintiff in order to settle a patent infringement and misappropriation of trade secrets claim. In exchange for the payment and licenses given, the company receives a promise to drop the patent infringement lawsuit, a covenant not to sue with respect to the misappropriation of trade secrets claim, and a license to use the patents subject to the litigation.

Mr. West noted that the different elements of the arrangement should be identified and that this identification requires an understanding of the nature of each item. In addition to the litigation settlement component, there could also be recognizable intangible assets related to the covenant not to sue and for patent licenses received. Regarding the license to patents given to the plaintiff, Mr. West noted:

If the licenses are expected to be used by the plaintiff in their operations, it may be appropriate for the company to recognize revenue or income with a corresponding increase in litigation settlement expense. However, if the licenses are given as part of a litigation defense strategy and don't have value to the plaintiff, it seems unlikely that any revenue should be recognized.
With respect to the amount of consideration to allocate to each element of the transaction, Mr. West noted the following:

While EITF 00-21 was written for multiple element revenue arrangements, we believe that its allocation guidance is also useful to determine how to allocate consideration paid in a multiple element legal settlement. In this regard, we believe that it would be acceptable to value each element of the arrangement and allocate the consideration paid to each element using relative fair values. [Footnote omitted]

We believe that even though Mr. West was speaking about the separation guidance in EITF 00-21, which was codified in ASC 605-25 and has been superseded by ASC 606, it is still appropriate for an entity to consider the principles of separation of performance obligations within the revenue guidance in ASC 606. ASC 606 includes guidance on how to allocate consideration to different elements of a contract with a customer that are partially within the scope of ASC 606 and partially within the scope of another topic as shown below.

**Connecting the Dots**

In an agreement that contains a settlement of a litigation component and a revenue contract with a customer, an entity should bifurcate the revenue element and the nonrevenue element (i.e., litigation) and allocate the consideration to both elements in a manner consistent with Mr. West’s remarks and ASC 606. There may be situations in which the entity has clear, compelling evidence that there is little to no value related to the litigation settlement; in those situations, the entire arrangement should be accounted for as a single element under ASC 606. When the entity determines that the entire arrangement should be accounted for as a single element under ASC 606, allocating consideration for the entire arrangement to the revenue element may be appropriate; however, we do not believe that the entity should apply the residual method, in which all proceeds are allocated to the revenue element by default.

The discussion above applies to both gain and loss contingencies that are settled by entering into a revenue contract with a customer. See Section 3.2.5 of Deloitte’s Revenue Roadmap for further discussion of contracts that include both revenue and nonrevenue elements. Section 7.2.2 of the Revenue Roadmap addresses estimating stand-alone selling prices, including application of the residual method.
2.2.6 Incurrence of a Future Cost of Doing Business

The incurrence of an obligation may represent the settlement of a past liability or a future cost of doing business. The settlement of a lawsuit by agreeing to make a cash payment in the absence of other elements of the settlement clearly represents the settlement of a past liability that should be accrued immediately. Signing an employment contract that guarantees an executive a fixed salary clearly represents a future cost of doing business that should be accrued as the executive performs service. However, it is not always clear how to distinguish between settlement of a past liability and the incurrence of a future cost of doing business. Companies sometimes settle litigation by altering the terms of future business arrangements, which calls into question whether a present liability has been incurred.

Accordingly, an entity must consider all facts and circumstances to determine whether an obligation represents the settlement of past liabilities or a cost of doing business in the future. Sometimes it can be argued that the facts and circumstances support both views, as demonstrated in the example below.

Example 2-5

**Differentiating Between Settlement of a Past Liability and a Future Cost of Doing Business**

The Coal Industry Retiree Health Benefit Act of 1992 (the “Act”) imposed a requirement on certain entities in the coal industry to make payments to fund medical and death benefits for retirees. ASC 930-715-25-1 states that “[e]ntities that currently have operations in the coal industry shall account for their obligation under the Act . . . either as participation in a multiemployer plan,” which would be expensed as payments are made, “or [as] a liability imposed by the Act,” which would be accrued immediately. The decision to allow such an accounting choice reflects the difficulty of differentiating between the settlement of a past liability and the incurrence of a future cost of doing business.

The incurrence of a future cost of doing business is often indicated by a payment stream that is contingent upon the future sale of products or services in the ordinary course of business (e.g., royalties due a licensor for the license and use of intellectual property). The future sale would be considered the event giving rise to the liability. Additional evidence that a payment is, in substance, a future cost of doing business is the inability to currently estimate the amount. It may not be possible to reasonably estimate a payment that is contingent upon a measure such as future sales volume. Thus, a future cost of doing business would often fail to qualify for recognition under ASC 450-20-25-2 because the obligating event has not yet occurred or the amount is not reasonably estimable or both.

Example 2-6

**Liability Settled by Incurring a Future Cost of Doing Business**

A group of entities in the tobacco industry settles litigation with a governmental body by agreeing to higher future taxation. Under the terms of the agreement, each company in the industry will pay a portion of the settlement in proportion to its respective market share in the preceding year. If a company exits the tobacco industry, no additional payments are due.

The terms of the agreement specifically preclude payment of the settlement out of existing assets; rather, payments must be funded through future increases in product prices. Because the settlement costs will be passed through to the end consumer, the event giving rise to the liability is the sale of products during future periods. No present obligation has been incurred given that the tobacco company could exit the tobacco industry immediately and avoid the settlement payment. As a result, a liability should be recorded when sales occur in the following year on the basis of a pro rata portion of the following year’s annual payment to the governmental body.
An entity may sometimes agree to settle a claim by agreeing to offer the claimant(s) a price concession on future purchases of the entity’s goods or services by the claimant(s). In such a scenario, the claimant(s) will be required to make an independent future purchasing decision to realize the benefit of the settlement. An entity that is obligated to provide such price concessions in connection with a settlement will need to assess whether (1) the settlement represents a liability that should be currently recognized for the estimated settlement amount or (2) the settlement should be accounted for as a sales incentive in accordance with ASC 606, which generally results in the entity’s accounting for the sales incentive at the time the claimant(s) uses the price concession in connection with the purchase of the entity’s goods/services.

While significant judgment may be required to determine the appropriate accounting, a settlement with an existing customer (or group of customers) that entitles such customer(s) to future price concessions for goods or services that the entity believes on the basis of compelling evidence that such customer(s) would have purchased in the absence of the concession could represent a fact pattern whereby the entity may conclude that liability recognition is appropriate, assuming a reasonable estimate can be made. Alternatively, a settlement with a claimant(s) for future price concessions of the entity’s goods or services whereby there was no preexisting customer/vendor relationship may be indicative of a fact pattern in which such a settlement is in substance more akin to a future price concession that should be accounted for in accordance with ASC 606 rather than a settlement of a prior liability. If the former view was taken for such a fact pattern (i.e., the settlement should be accounted for as a liability), the entity may nonetheless conclude that it is unable to reasonably estimate the future price concession (e.g., in a circumstance in which there is an insufficient sales history with the claimant(s) or the concession is stated as a percentage of future sales of an unknown quantity), meaning that not all of the recognition criteria in ASC 450-20-25-2 are met. Irrespective of when the future price concession is accounted for, any settlement with a customer or a vendor would need to be evaluated in accordance with ASC 606 or ASC 705-20, respectively, regarding the income statement presentation of the settlement. See below for further discussion of the income statement presentation for settlements with customers and vendors.

### 2.2.6.1 Income Statement Classification for Settlements With Customers and Vendors

When determining the appropriate income statement classification of a litigation settlement when the settlement counterparty is a customer, the entity should first look to the guidance on consideration payable to a customer in ASC 606-10-32-25 through 32-27 to determine whether the consideration is for a distinct good or service for which the entity can reasonably estimate fair value and, if so, classify such settlement payments in accordance with applicable U.S. GAAP. For example, a litigation element may be accounted for in accordance with ASC 450, or inventory purchases may be accounted for in accordance with ASC 330.

If settlement consideration payable to a customer is in exchange for a distinct good or service but the fair value cannot be reasonably estimated, the settlement consideration should be recognized as a reduction in transaction price. For example, in a litigation settlement with a customer, an entity may determine that an element of the consideration pertains to settling the litigation and therefore is representative of a distinct benefit. The entity may have historical experience in settling similar cases and therefore may be able to readily determine the distinct litigation settlement benefit; however, unless the entity can reasonably estimate the fair value of the litigation settlement element, the entire settlement amount should be accounted for as a reduction in transaction price. For additional information regarding consideration payable to a customer, see Section 6.5 of Deloitte’s Revenue Roadmap.
Similarly, regarding classification of the settlement when payments are received from a vendor, entities
should consider ASC 705-20, as discussed in Section 6.5.2.1 of Deloitte's Revenue Roadmap, as well as
the gain contingency recognition guidance as discussed in Chapter 3 of this Roadmap.

### 2.3 Recognition

**ASC 450-20**

25-1 When a loss contingency exists, the likelihood that the future event or events will confirm the loss or
impairment of an asset or the incurrence of a liability can range from probable to remote. As indicated in the
definition of contingency, the term loss is used for convenience to include many charges against income that
are commonly referred to as expenses and others that are commonly referred to as losses. The Contingencies
Topic uses the terms probable, reasonably possible, and remote to identify three areas within that range.

25-2 An estimated loss from a loss contingency shall be accrued by a charge to income if both of the following
conditions are met:

a. Information available before the financial statements are issued or are available to be issued (as
discussed in Section 855-10-25) indicates that it is probable that an asset had been impaired or a liability
had been incurred at the date of the financial statements. Date of the financial statements means the
end of the most recent accounting period for which financial statements are being presented. It is
implicit in this condition that it must be probable that one or more future events will occur confirming
the fact of the loss.

b. The amount of loss can be reasonably estimated.

The purpose of those conditions is to require accrual of losses when they are reasonably estimable and relate
to the current or a prior period. Paragraphs 450-20-55-1 through 55-17 and Examples 1–2 (see paragraphs
450-20-55-18 through 55-35) illustrate the application of the conditions. As discussed in paragraph 450-20-
50-5, disclosure is preferable to accrual when a reasonable estimate of loss cannot be made. Further, even
losses that are reasonably estimable shall not be accrued if it is not probable that an asset has been impaired
or a liability has been incurred at the date of an entity's financial statements because those losses relate to a
future period rather than the current or a prior period. Attribution of a loss to events or activities of the current
or prior periods is an element of asset impairment or liability incurrence.

When an entity obtains information before the financial statements are issued or available to be issued
indicating that it is probable that a future event will confirm a financial statement loss that occurred on
or before the date of the financial statements, the entity should accrue such a loss contingency provided
that the loss can be reasonably estimated.
The flowchart below provides an overview of the contingent liability recognition criteria, taking into consideration all information about the loss that becomes available before the financial statements are issued (or are available to be issued).

A contingent liability is not recognized when either (1) it is not probable that a future event will confirm that a loss had been incurred on or before the date of the financial statements or (2) the amount of the loss is not reasonably estimable. The entity should carefully evaluate whether appropriate disclosure is necessary to keep the financial statements from being misleading. See additional disclosure requirements in Section 2.8.

2.3.1 Assessing the Probability of Whether a Loss Has Been Incurred

2.3.1.1 “Probable,” “Reasonably Possible,” and “Remote”

For an entity to recognize a loss contingency, ASC 450 requires that it be probable that one or more future events will occur or fail to occur, thereby confirming a loss. ASC 450-20 categorizes loss contingencies on the basis of the likelihood of occurrence as follows:

<table>
<thead>
<tr>
<th>ASC 450-20 — Glossary</th>
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<tbody>
<tr>
<td><strong>Probable</strong></td>
</tr>
<tr>
<td>The future event or events are likely to occur.</td>
</tr>
<tr>
<td><strong>Reasonably Possible</strong></td>
</tr>
<tr>
<td>The chance of the future event or events occurring is more than remote but less than likely.</td>
</tr>
<tr>
<td><strong>Remote</strong></td>
</tr>
<tr>
<td>The chance of the future event or events occurring is slight.</td>
</tr>
</tbody>
</table>

Although ASC 450-20 defines each of these terms, it provides no quantitative thresholds. The word “probable” is not intended to require virtual certainty before a loss is accrued. However, “likely to occur” is a higher threshold than “more likely than not,” which is generally considered to be a minimum of a 50.1 percent chance of occurrence.
“Probable” is discussed in paragraph 49 of the Background Information and Basis for Conclusions of FASB Statement 114, which states, in part:

“[P]robable’ . . . has, in the case of banks, come to mean ‘virtually certain,’ rather than ‘more likely than not,’” and “the ‘probable’ requirement as it is sometimes applied has unduly delayed loss recognition . . . of problem assets.” The Board did not intend “probable” to mean “virtually certain to occur.” The Statement 5 definition of probable states that “the future event or events are likely to occur” (emphasis added). The Board recognizes that application of the term probable in practice requires judgment, and to clarify its intent the Board has reiterated the guidance in paragraph 84 of Statement 5 in paragraph 10 of this Statement. The term probable is used in this Statement consistent with its use in Statement 5. This Statement does not specify how a creditor should determine that it is probable that it will be unable to collect all amounts due according to a loan's contractual terms.

The application of a probable threshold is also addressed in ASU 2014-15, which discusses “probable” in the context of determining what constitutes substantial doubt about an entity's ability to continue as a going concern. Further, ASU 2014-15 observes that “probable” in the ASC master glossary's definition of “substantial doubt about an entity's ability to continue as a going concern” carries the same meaning that it does in ASC 450's definition of the word. The ASU's general discussion of a Board member's dissenting view indicates, in part:

As mentioned in paragraph BC17, a commonly cited academic paper (Boritz, 1991) noted that the threshold for the substantial doubt likelihood of an entity being unable to meet its obligations is between 50 and 70 percent. The guidance in this Update increases that threshold to probable, which many assert as being in the 70–75 percent range.

While we believe that diversity in practice exists related to what percentage likelihood entities consider “probable” to represent, we generally believe that in a manner consistent with the discussion in ASU 2014-15, the use of “probable” would require at least a 70 percent chance of occurrence.

A loss contingency is recognized only when the likelihood of a future event's occurrence indicates that it is probable that a loss has occurred (assuming the loss contingency is also reasonably estimable). If the likelihood of a future event's occurrence is only reasonably possible, entities should provide appropriate disclosures as required under ASC 450-20-50, although loss accrual is not appropriate. For events for which the likelihood that a loss has been incurred is remote, recognition is not appropriate and disclosure is not required under ASC 450-20; however, entities should use judgment in determining whether omitting disclosures would cause the financial statements to be misleading. See Section 2.8 for disclosure considerations.

Entities may need to consider various factors and apply considerable judgment in determining the likelihood of occurrence of a future event or the nonoccurrence of a future event that will confirm whether a loss has been incurred on the date of the financial statements. Specifically, in the case of class action lawsuits or litigation, entities may need to consider (among other things) the opinion of in-house or external legal counsel, the entity's history and experience with similar cases, prior case law, how the entity intends to respond, and the nature of the settlement mechanism.

Certain contingencies are not considered probable until the underlying future events occur because of various external factors involved in the determination of the probability threshold. Examples of such underlying future events include casualty events, the enactment of proposed legislation, the successful completion of an initial public offering, and the occurrence of a business combination, all which are discussed in the sections below.
2.3.1.2 Occurrence of a Business Combination or Successful Completion of an IPO

Certain liabilities are contingent on the occurrence of a business combination or the successful completion of an initial public offering (IPO). For example, a litigation settlement may be payable upon completion of an IPO, or a restructuring plan may be adopted upon consummation of a business combination.

There are many external factors and uncertainties that can affect the successful completion of an IPO. These external factors and uncertainties make it difficult to determine whether the probability threshold has been met before the effective date of an IPO. Therefore, the incurrence of a liability contingent on an IPO cannot be considered probable until the IPO is effective.

In a manner similar to the successful completion of an IPO, the consummation of a business combination is contingent on numerous circumstances, including the completion of due diligence and the obtaining of any necessary shareholder or regulatory approval. In addition, a business combination is an event that requires discrete accounting when the combination is consummated. Therefore, one of the events that obligates the entity and therefore gives rise to the liability has not occurred until the combination has occurred. Because of the uncertainties involved in a business combination and the discrete nature of business combinations, a liability should not be accrued until the business combination is consummated. This position is consistent with the guidance in ASC 420 and ASC 805-20-55-50 and 55-51, which indicates that the liability for termination benefits and curtailment losses that will be triggered by the consummation of a business combination should be recognized upon completion of the business combination, not when the business combination becomes probable.

This position does not affect or apply to the freestanding derivative contracts or embedded derivative features that are within the scope of ASC 815 (e.g., a put option contingent on an IPO or a conversion feature contingent on a target stock price).

2.3.1.3 Proposed Legislation

The enactment of legislation by a governmental authority frequently gives rise to a liability. Paragraph 39 of FASB Concepts Statement 6 states, in part:

Although most liabilities result from agreements between entities, some obligations are imposed on entities by government or courts or are accepted to avoid imposition by government or courts (or costly efforts related thereto), and some relate to other nonreciprocal transfers from an entity to one or more other entities. Thus, taxes, laws, regulations, and other governmental actions commonly require business enterprises (and sometimes not-for-profit organizations) to pay cash, convey other assets, or provide services either directly to specified governmental units or to others for purposes or in ways specified by government.

In some circumstances, a company may expect that pending legislation will give rise to a liability upon enactment. However, a liability should not be accrued in advance of enactment even if the entity believes such enactment to be probable. Future laws or changes in laws should not be anticipated when an entity is accruing a liability in accordance with ASC 450-20-25-2. Before enactment of a law, the specific content of the final law is uncertain. Substantive changes to the law may materially affect the nature, timing, and extent of resources a company will be required to expend. Accounting for liabilities should reflect the provisions of enacted laws on a jurisdiction-by-jurisdiction basis. This treatment is consistent with the guidance on changes in income tax laws in paragraph 112 of the Basis for Conclusions of FASB Statement 109, which states, in part:

Conceptually, it could be argued that an enterprise should anticipate the tax effect of an expected future change in tax law . . . . The Board believes, however, that recognition of those tax consequences in the year that a change occurs permits a more reliable measurement of the economic effects of an enacted change in tax law.
Chapter 2 — Loss Contingencies and Commitments

Connecting the Dots
The enactment date is the date on which all steps in the process for legislation to become law have been completed (e.g., in the United States, this could be the case when the president signs the legislation and it becomes law). For rules and regulations issued by federal regulatory agencies to implement enacted U.S. laws, the enactment date is generally the date on which final rules or regulations promulgated by the federal regulatory agency are published in the Federal Register, which may differ from the effective date of such rules or regulations. Entities may need to exercise considerable judgment and obtain the assistance of legal counsel in determining (1) the enactment date of laws and regulations implemented in jurisdictions (i.e., local, state, federal, or foreign) or (2) when regulations issued by governmental agencies to implement and interpret these laws are enacted. For an illustrative example of an enacted rule published in the Federal Register, see Section 5.4.1 of Deloitte’s A Roadmap to Accounting for Environmental Obligations and Asset Retirement Obligations.

Example 2-7

Legal Liabilities as a Result of the Enactment of Legislation
The European Parliament and the Council of the European Union (the “Council”) issue two types of legislation: (1) regulations and (2) directives. Regulations become law upon passage by the European Parliament and the Council. Directives are fundamental objectives to be achieved by laws, regulations, and administrative provisions enacted by the individual member states of the European Union. Although directives require passage by the European Parliament and the Council, they do not become law until implemented by laws, regulations, and administrative provisions of the respective member states. To comply with a directive, member states must enact such a measure within 18 months of the directive’s passage by the European Parliament and the Council.

The passage of a directive by the European Parliament and the Council does not satisfy the criteria for recognition of a liability under ASC 450-20-25-2 and paragraph 36(c) of Concepts Statement 6 because a legal obligation has not been established. The obligating event is the enactment of laws, regulations, and administrative provisions to comply with a directive. Although it may be probable that passage of a directive by the European Parliament and the Council will result in the enactment of measures needed to comply with the directive, future laws or changes in laws should not be anticipated. Rather, liabilities should be recognized in a manner that reflects the provisions of enacted laws on a jurisdiction-by-jurisdiction basis.

2.3.1.4 Assessing Whether a Loss Is Reasonably Estimable
When accruing a loss, an entity must determine in accordance with the recognition criteria in ASC 450-20-25-2 whether the loss is probable and reasonably estimable. Recognition of a loss that cannot be reasonably estimated, even if it is probable that the loss has been incurred, would impair the integrity of the financial statements. Alternatively, the entity should not delay accrual of a loss because of the inability to estimate a single amount. The ability to estimate a loss within a range would indicate some amount of a loss has occurred, and therefore, in accordance with ASC 450-20-25-2(b), the entity should accrue a liability. The entity may use past experience or other information to demonstrate its ability to reasonably estimate the loss.

If both recognition criteria under ASC 450-20-25-2 are met, the estimated loss will be charged to income. ASC 450-20-25-7 indicates that if a loss cannot be accrued in the period when it is determined that it is probable that a loss has been incurred “because the amount of loss cannot be reasonably estimated, the loss shall be charged to the income of the period in which the loss can be reasonably estimated and shall not be charged retroactively to an earlier period. All estimated losses for loss contingencies shall be charged to income rather than charging some to income and others to retained earnings as prior period adjustments.”

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2.3.1.5 General Reserves and Risk of Loss From Future Events

ASC 450-20-25-8 specifically indicates that “[g]eneral or unspecified business risks” should not be accrued in the financial statements since they do not meet the probable and reasonably estimable requirements of ASC 450-20-25-2. Therefore, it is not acceptable to record an accrual for general contingencies in an attempt to address uncertainties in the financial statements that may not be probable or reasonably estimable.

In addition, mere exposure because of uninsured or underinsured risk of loss or damage of an entity’s property by fire, explosion, or other hazards does not mean that an asset has been impaired or a liability has been incurred, and therefore such risk of loss should not be accrued as a liability under ASC 450-20. To recognize such a liability related to exposure because of uninsured or underinsured risk would be to recognize a liability under ASC 450-20 when it is not probable that the uncertain future events will confirm that a loss occurred on or before the date of the financial statements. As noted in ASC 450-20-55-7 by way of example, “an entity with a fleet of vehicles should not accrue for injury to others or damage to the property of others that might be caused by those vehicles in the future even if the amount of those losses may be reasonably estimable.” However, ASC 450-20-55-8 indicates that an uninsured loss resulting from injury to others or damage to property of others is accrued as a loss contingency if that event took place before the date of the financial statements and the entity is able to reasonably estimate the amount of such a loss through prior experience or information available.

A risk of loss from future events that interrupt the normal course of business is not considered “probable” until those events occur. Further, the costs of insurance coverage and the availability of coverage for certain types of risk (e.g., professional malpractice, product liability, director’s and officer’s liability, and pollution liability) have a significant effect on many companies. To minimize premium costs or to satisfy insurers, some companies have modified the terms of their coverage (e.g., by increasing the amounts of deductibles or reducing coverage or both); others are forming captive insurance companies by using a self-insurance method. It is not appropriate to accrue for uninsured or underinsured expected losses in a systematic fashion before such losses occur. Before the issuance of FASB Statement 5, many entities that did not carry insurance against certain risks, such as property damage from fire or explosion, charged earnings in a systematic fashion (e.g., as if an insurance premium were being expensed) to establish an insurance reserve against which actual losses could then be charged. However, charges in lieu of insurance are not permitted under ASC 450.

2.3.2 Other Recognition Considerations

2.3.2.1 Unasserted Claims

Unasserted claims are possible claims or assessments of which an entity has not yet been notified by the injured party or potential claimant. Entities often are exposed to financial loss before the commencement of a formal claim. Litigation may be expected as a result of a past action. Alternatively, an entity may expect a current government investigation to result in a formal claim upon the investigation’s completion.

To determine under which circumstances an unasserted claim should be accrued, an entity must first determine whether a past event has triggered a loss contingency. If such a past event has been determined, the entity must then determine the probability that (1) a lawsuit will be filed or a claim will be asserted against it and (2) such a lawsuit or claim will result in an unfavorable outcome for the entity. If it is probable that an unasserted claim will result in an unfavorable outcome for the entity, and if the amount of the loss can be reasonably estimated, the entity should accrue a loss contingency in accordance with ASC 450-20-25-2. Additional disclosure may be required if it is reasonably possible that there is exposure to loss in excess of the amount accrued.
If an unfavorable outcome is only reasonably possible, or if the amount of the loss cannot be reasonably estimated, an amount should not be accrued, but disclosure would be required under ASC 450-20-50. See Section 2.8 for the disclosure considerations.

Entities may incur losses as a result of incidents that occur before the date of the financial statements but are not reported by a claimant until a later date. ASC 720-20-25-14 requires the accrual for incurred but not reported (IBNR) claims if both criteria in ASC 450-20-25-2 are met. Examples 2-8 and 2-9 below illustrate the application of the recognition criteria under ASC 450-20 to unasserted claims.

**SEC Considerations**

For certain IBNR claims, such as asbestos liability claims, entities may establish a liability for a rolling fixed number of years (i.e., the entity is able to reliably estimate its expected liability for IBNR for the next 20 years of claims, but it is unable to reliably estimate a liability for the period beyond 20 years). Typically, these liabilities have years, and sometimes decades, of settlement claims history. We have observed that the SEC staff has frequently commented on these rolling fixed term liabilities and has asked companies to provide more detail about the process undertaken, including the related ICFR, by management to conclude that it could not estimate for the period beyond a specific time horizon.

**Example 2-8**

**Assessing Accrual Related to an Outcome of an Incomplete Investigation**

Company R is being investigated by a government agency for potential breach of contract and allegations of illegal pricing for prior sales transactions. As of year-end, the government has not filed any charges or specified a monetary penalty against R for these matters. To determine whether accrual or disclosure of the contingency is appropriate in R's year-end financial statements, R's management must first determine the probability that a lawsuit will be filed or a claim will be asserted against R. If the filing of a lawsuit or the assertion of a claim is probable in management's judgment, management must determine the probability that such a lawsuit or claim will result in an unfavorable outcome for R. If an unfavorable outcome is probable and the amount of the loss can be reasonably estimated, accrual of the loss is required. If the amount of the loss cannot be reasonably estimated, no accrual is required; however, R should disclose the contingency. Further, if an unfavorable outcome is only reasonably possible but not probable, R should disclose the contingency.

**Example 2-9**

**Accrual of Probable Settlement Costs**

Company T has decided to abandon certain distributor agreements that it had in place. Company T believes that it will be involved in legal actions brought by the distributors and that it is probable that the company will incur costs to settle these actions. To the extent that it is probable that these claims will be asserted and will result in an unfavorable outcome for T, it should accrue a loss under ASC 450-20 if the settlement amount can be reasonably estimated.

**2.3.2.2 Loss Recognition Before the Occurrence of a Casualty Event for an Insurance Company**

One of the most controversial issues addressed in ASC 450-20 is related to whether a property and casualty insurance company should recognize a liability for future losses resulting from catastrophes. When an insurance company issues a policy, it assumes the risk that a catastrophe (e.g., a hurricane) might occur within the policy coverage period. Insurance companies have asserted that they are able to predict the occurrence rate of catastrophes and related losses by using actuarial methods based on past occurrences. Insurance companies use such methods for rate-setting purposes and therefore, many believe that the losses are reasonably estimable and should be accrued.
However, the FASB concluded in paragraph 41 of FASB Statement 5 (codified in ASC 944-40-55-3) that catastrophe reserves fail to satisfy the conditions of ASC 450-20 for accrual because losses from potential future catastrophes over the relatively short periods covered by policies in force cannot be reasonably estimated. In addition, unless a catastrophe occurs within the policy period, no asset is impaired and no liability is incurred as of the date of the financial statements; therefore, no accrual for a catastrophe loss should be made. On the other hand, a property and casualty insurer is required to accrue losses from catastrophes that occurred before the date of the financial statements even though claims have not been submitted by policyholders if (1) it is probable that those claims will be made and (2) a reasonable estimate of the loss can be made. Accrual of a premium deficiency is also required by ASC 450-20 and ASC 944-60.

2.3.2.3 Litigation, Claims, and Assessments

A common uncertainty many entities will encounter is the risk of litigation. Class actions, product liabilities, lawsuits, and actions brought by government agencies are not uncommon, and an entity may need to accrue or disclose contingencies related to the risk of such litigation (e.g., the potential future obligation to pay an uncertain amount as a result of past activities) in the financial statements.

Adverse consequences of litigation could include the obligation to pay damages, the imposition of fines and penalties, the need to repay consideration from a revenue contract that was previously received, and even discontinuation of certain operations. Further, the entire nature of the entity may change as a result of the litigation (e.g., the entity may seek protection from the litigation through bankruptcy).

Types of litigation that an entity may face include the following:

- Antitrust.
- Restraint of trade.
- Breach of contract.
- Patent infringement.
- Product liability.
- Violation of federal securities laws.
- Government actions.
- Discrimination.
- Environmental protection matters.
- Violation of wage and price guidelines or controls.
- Renegotiation of government contracts.
- Income tax disputes.
- Violation of other laws and regulations (e.g., the Foreign Corrupt Practices Act).
In determining whether an accrual is required in connection with litigation, claims, and assessments, an entity should consider various factors that include, but are not limited to, the following:

- **The nature of the settlement mechanism** — The parties involved may have agreed to use a settlement mechanism other than the court system that is binding on the parties. Accordingly, it is necessary to evaluate, on the basis of the specific facts and circumstances, the ability of the party that is subject to an adverse legal judgment to appeal the matter.

- **The progress of the case** — If a planned appeal is not the entity's first appeal of an adverse judgment (i.e., the entity has been unsuccessful in prior appeals of the judgment), the entity should consider the results, findings, or both of the earlier rulings when assessing its evidence for and against liability recognition.

- **The opinions or views of legal counsel and other advisers**:
  - A legal analysis usually will include counsel's opinion regarding the likelihood that the entity will prevail on appeal. For example, a legal opinion may state counsel's belief that the entity's chance for a successful appeal is probable, more likely than not, or reasonably possible. The terms “probable” and “reasonably possible” do not have precise quantitative thresholds and may be interpreted and applied differently by different parties, as described in Section 2.3.1.1. The entity's management should understand the meaning of such terms in the context of the legal opinion related to the entity's specific facts and circumstances to compare management's assertions about the likelihood of success on appeal with those of counsel.
  - Management should review the basis for counsel's conclusions and assess whether the reasons cited by counsel to support its assessment are consistent with the evidence used by the entity to support its decision about whether to record a loss contingency.
  - Management should fully consider any qualifications or conditions that counsel identified as affecting its assessment. In interpreting language used by counsel to explain its conclusion, management may find it helpful to consider the guidance applicable to audits of financial statements contained in AICPA auditing standards AU-C Section 620 and AU-C Section 501.
  - Counsel's opinion is a critical piece of evidence that needs to be analyzed carefully. Counsel's expression of an opinion that an entity will be successful on appeal does not, in itself, support a conclusion that an accrual of a loss is not warranted. In addition, ASC 450-20-55-12(c) notes that “the fact that legal counsel is unable to express an opinion that the outcome will be favorable to the entity should not necessarily be interpreted to mean that the condition in paragraph 450-20-25-2(a) is met.” However, when the entity has received an adverse legal judgment, counsel's inability to express an opinion may leave the entity with insufficient positive evidence to overcome the judgment.

- **The experience of the entity or other entities in similar cases** — The prior experiences of the entity or other entities with similar litigation may provide additional evidence about the entity's likelihood of success. For example, management could consider possible outcomes specific to (1) certain jurisdictions, (2) certain courts, (3) the use of certain defense strategies, or (4) other related aspects of the litigation.

- **Prior case law for similar cases** — Gaining an understanding of prior case law may enable the entity to identify certain precedents that could affect the likelihood of its success.
• **Management’s decision regarding how the entity intends to respond:**
  - Although certain adverse legal judgments may be appealed, the entity's decision to appeal will depend on a variety of factors. The entity should consider its specific facts and circumstances when assessing the likelihood that it will seek an appeal.
  - Because an adverse legal judgment may involve multiple components, the entity should analyze each component thoroughly to determine whether a litigation accrual should be recorded. For example, the entity should determine whether it will appeal all components of the judgment or only selected components.

• **The entity’s intended basis for an appeal** — As discussed above, an understanding of the legal basis for the entity's appeal, combined with a review of prior case law or the experiences of the entity or other entities in similar cases, may serve as evidence that helps the entity gauge the likelihood that it will prevail on appeal.

• **The audit committee’s assessment of the entity’s opportunity for appeal** — The audit committee's assessment of the entity's opportunity for appeal, considered along with the assessments of internal or outside counsel and the entity's management, may constitute additional information about the entity's defense strategy and its chances for success on appeal.

Example 1 in ASC 450-20-55-18, Cases A through D of Example 2 in ASC 450-20-55-22, and Example 2-10 illustrate the accounting for various litigation scenarios.

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**Example 1: Litigation Open to Considerable Interpretation**

55-18 An entity may be litigating a dispute with another party. In preparation for the trial, it may determine that, based on recent developments involving one aspect of the litigation, it is probable that it will have to pay $2 million to settle the litigation. Another aspect of the litigation may, however, be open to considerable interpretation, and depending on the interpretation by the court the entity may have to pay an additional $8 million over and above the $2 million.

55-19 In that case, paragraph 450-20-25-2 requires accrual of the $2 million if that is considered a reasonable estimate of the loss.

55-20 Paragraphs 450-20-50-1 through 50-2 require disclosure of the nature of the accrual, and depending on the circumstances, may require disclosure of the $2 million that was accrued.

55-21 Paragraphs 450-20-50-3 through 50-8 require disclosure of the additional exposure to loss if there is a reasonable possibility that the additional amounts will be paid.

**Example 2: Multiple Case Litigation Example**

55-22 The following Cases illustrate application of the accrual and disclosure requirements in the following stages of litigation:

a. The trial is complete but the damages are undetermined (Case A).

b. The trial is incomplete but an unfavorable outcome is probable (Case B).

c. The trial is incomplete and unfavorable outcome is reasonably possible (Case C).

d. There is a range of loss and one amount is a better estimate than any other (Case D).
### Case A: Trial Is Complete but Damages Are Undetermined

##### 55-23
An entity is involved in litigation at the close of its fiscal year and information available indicates that an unfavorable outcome is probable. Subsequently, after a trial on the issues, a verdict unfavorable to the entity is handed down, but the amount of damages remains unresolved at the time the financial statements are issued or are available to be issued (as discussed in Section 855-10-25). Although the entity is unable to estimate the exact amount of loss, its reasonable estimate at the time is that the judgment will be for not less than $3 million or more than $9 million. No amount in that range appears at the time to be a better estimate than any other amount.

##### 55-24
In this Case, paragraph 450-20-30-1 requires accrual of the $3 million (the minimum of the range) at the close of the fiscal year.

##### 55-25
Paragraphs 450-20-50-1 through 50-2 require disclosure of the nature of the contingency and, depending on the circumstances, may require disclosure of the amount of the accrual.

##### 55-26
Paragraphs 450-20-50-3 through 50-8 require disclosure of the exposure to an additional amount of loss of up to $6 million.

### Case B: Trial Is Incomplete but Unfavorable Outcome Is Probable

##### 55-27
Assume the same facts as in Case A, except it is probable that a verdict will be unfavorable and the trial has not been completed before the financial statements are issued or are available to be issued (as discussed in Section 855-10-25). In that situation, the condition in paragraph 450-20-25-2(a) would be met because information available to the entity indicates that an unfavorable verdict is probable. An assessment that the range of loss is between $3 million and $9 million would meet the condition in paragraph 450-20-25-2(b).

##### 55-28
In this Case, if no single amount in that range is a better estimate than any other amount, paragraph 450-20-30-1 requires accrual of $3 million (the minimum of the range) at the close of the fiscal year.

##### 55-29
Paragraphs 450-20-50-1 through 50-2 require disclosure of the nature of the contingency and, depending on the circumstances, may require disclosure of the amount of the accrual.

##### 55-30
Paragraphs 450-20-50-3 through 50-8 require disclosure of the exposure to an additional amount of loss of up to $6 million.

### Case C: Trial Is Incomplete and Unfavorable Outcome Is Reasonably Possible

##### 55-31
Assume the same facts as in Case B, except the entity had assessed the verdict differently (for example, that an unfavorable verdict was not probable but was only reasonably possible). The condition in paragraph 450-20-25-2(a) would not have been met and no amount of loss would be accrued. Paragraphs 450-20-50-3 through 50-8 require disclosure of the nature of the contingency and any amount of loss that is reasonably possible.

### Case D: Range of Loss and One Amount Is a Better Estimate Than Any Other

##### 55-32
Assume that in Case A and Case B the condition in paragraph 450-20-25-2(a) has been met and a reasonable estimate of loss is a range between $3 million and $9 million but a loss of $4 million is a better estimate than any other amount in that range.

##### 55-33
In this Case, paragraph 450-20-30-1 requires accrual of $4 million.

##### 55-34
Paragraphs 450-20-50-1 through 50-2 require disclosure of the nature of the contingency and, depending on the circumstances, may require disclosure of the amount of the accrual.

##### 55-35
Paragraphs 450-20-50-3 through 50-8 require disclosure of the exposure to an additional amount of loss of up to $5 million.
Example 2-10

**Broker-Dealer Dispute With Investors**

Company A, a broker-dealer, markets and sells investments in certain financial products. The investments do not contain an option for investors to put the investments back to A. Company A later faces criticism and potential litigation for misleading investors about the economic characteristics of the investments. As a result, A enters into a settlement agreement that gives each investor the right to demand that A repurchase the investment for cash equal to its par value on a specified future date (or range of dates) upon physical delivery of the investment to A.

The accounting considerations depend on whether A has entered into a legally enforceable settlement agreement that meets the definition of a firm commitment (i.e., an “enforceable settlement agreement”).

**Accounting Before Settlement Agreement**

Before an enforceable settlement agreement or the resolution of any associated litigation, the potential that a broker-dealer has incurred a loss in connection with its past selling or marketing of investments is a loss contingency within the scope of ASC 450-20 and should be evaluated as a contingent liability for recognition and disclosure.

Under ASC 450-20-25-2, if information that is available before the issuance of financial statements (or before they are available to be issued) indicates that (1) it is probable that a liability has been incurred as of the date of the financial statements in connection with the broker-dealer’s past selling or marketing of investments and that (2) the amount of the loss can be reasonably estimated, the broker-dealer should accrue a liability for the contingency and recognize a related charge in current-period income. ASC 450-20-50-3 and 50-4 specify that if it is reasonably possible that a loss or an additional loss in excess of the amount of the loss accrued may have been incurred or the loss amount cannot be reasonably estimated, the broker-dealer should disclose the “nature of the contingency” and an “estimate of the possible loss or range of loss or a statement that such an estimate cannot be made.”

**Accounting Once a Settlement Agreement Becomes Legally Enforceable**

On the date A enters into an enforceable settlement agreement, the uncertainty regarding whether a loss has been incurred is resolved, and A must recognize an obligation for issuing the written put option.

If A determines that the written put option does not meet the definition of a derivative instrument under ASC 815-10, it would account for the option as a guarantee contract under ASC 460-10. Accordingly at initial recognition of the obligation undertaken in issuing the guarantee, A should apply ASC 460-10-30-3, which states, in part, that the amount initially recognized related to the written put option should be the greater of:

a. The amount that satisfies the fair value objective as discussed in the preceding paragraph

b. The contingent liability amount required to be recognized at inception of the guarantee by Section 450-20-30.

ASC 460-10-35 does not address subsequent measurement in detail; however, A would be expected to subsequently measure the put option in a manner consistent with the SEC staff’s long-standing position that written options should be marked to fair value through current-period earnings.
2.3.2.4 Evaluating the Impact of an Adverse Legal Judgment on the Recognition and Measurement of a Loss Contingency

In some cases, an entity may receive an adverse legal judgment for payment of a specific amount related to an event that occurred on or before the date of the financial statements. This judgment may be determined before the date of the financial statements, or after the date of the financial statements but before the financial statement issuance or the date that the financial statements are available to be issued. The entity may not have previously recognized a contingent liability for this matter because it did not believe that the criteria in ASC 450-20-25-2 had been met.

The rendering of an adverse legal judgment against an entity does not automatically trigger recognition of a liability for a loss contingency since the entity may be successful in overturning all or part of the original judgment on appeal. As mentioned above, ASC 450-20-25-2 requires entities to accrue, by a charge to income, an estimated loss from a loss contingency if (1) it is probable that a “liability had been incurred” and (2) the “amount of the loss can be reasonably estimated.” In determining the probability and the estimate of the loss, the entity must analyze all available information.

An adverse legal judgment constitutes significant objective evidence of the probability that an entity has incurred a liability as of the date of the financial statements. Consequently, for an entity that intends to appeal the judgment to conclude that no liability has been incurred as of the date of the financial statements, evidence supporting nonrecognition must be sufficient to counterbalance the external legal determination (i.e., the adverse legal judgment) and any other similar evidence. That is, to support nonrecognition, the evidence as a whole must reduce the likelihood that a liability has been incurred as of the date of the financial statements to a level below the probable threshold under ASC 450-20; otherwise, a liability should be recognized as long as the amount of the liability is reasonably estimable.

After analyzing all of the available information as indicated in the section above, the entity that received the adverse legal judgment may conclude that no loss contingency accrual is necessary because one or both of the conditions in ASC 450-20-25-2 have not been met. However, the entity would still be required to disclose the contingency (in accordance with ASC 450-20-50-3) if it is at least reasonably possible that a loss has been incurred as of the date of the financial statements. It is unlikely that an entity that has received an adverse legal judgment will have sufficient information to conclude that the likelihood of a loss is remote. Also, it is likely that the disclosure would need to contain sufficient information to enable the financial statement user to understand the status of the litigation, the fact that an adverse judgment had been determined, and the factors the entity considered to determine that the loss should not be recognized.

If the entity is unable to or does not intend to appeal the adverse judgment or otherwise concludes in accordance with ASC 450-20-25-2(a) that it is probable that a liability has been incurred, the entity should determine whether the liability can be reasonably estimated in accordance with ASC 450-20-25-2(b). If a reasonable estimate of the liability is a range, the entity should apply the guidance in ASC 450-20-25-5 and ASC 450-20-30-1. That is, when one amount within a range appears to be a better estimate than any other amount within the range, that amount should be accrued; when no amount within the range is a better estimate than any other amount, the minimum amount in the range should be recorded.
2.3.2.5 Accrual of Future Legal Costs

In determining the amount to accrue for a loss contingency involving litigation, entities have had to consider whether expected legal fees related to the litigation should be accrued when the loss contingency is initially recognized or when the legal services are actually provided at a future date. Practice regarding this issue has varied owing to the absence of definitive guidance. As a result, the SEC staff suggested that the EITF Agenda Committee consider the need to add an item to the EITF agenda to address this issue.

The EITF Agenda Committee discussed this potential issue before the January 1997 meeting but did not reach a recommendation for the Task Force. The Agenda Committee considered whether the Task Force should recommend that the FASB undertake the project so that it receives adequate due process, but the Agenda Committee did not reach a conclusion. The Agenda Committee also discussed the existing practice regarding the accrual of legal fees associated with a loss contingency and determined that it might be helpful to ask the Task Force for input on whether such practice is diverse. The SEC observer indicated that the SEC staff will need to consider whether to provide interim guidance while the EITF or the FASB decides whether to address this issue.

In addition, the minutes of the January 23, 1997, EITF meeting contain the following discussion of this issue, which is also summarized in an SEC staff announcement codified in ASC 450-20-S99-2:

The Task Force Chairman reported on the meeting of the EITF Agenda Committee. The Task Force discussed a potential new issue relating to the accounting for legal costs expected to be incurred in connection with a FASB Statement No. 5, Accounting for Contingencies [codified as ASC 450-20], loss contingency. Some Task Force members observed that they believe practice typically has expensed such costs as incurred; however, other Task Force members suggested that practice may not be consistent in this area. The Task Force also discussed whether it should recommend that the FASB address this potential new issue but decided not to take any action. The Task Force declined to add this potential new issue to its agenda. The SEC Observer indicated that the SEC staff will attempt to better understand what practice is in this area and monitor the issue. The SEC Observer also noted that he would expect a registrant’s accounting policy to be applied consistently and APB Opinion No. 22, Disclosure of Accounting Policies [codified as ASC 235], requires disclosure of material accounting policies and the methods of applying those policies.

In the absence of further guidance from the FASB or the SEC staff, entities should apply the guidance above, which indicates that the decision to accrue legal costs on the basis of an estimate of future legal costs or expense when incurred is a matter of accounting policy that should be consistently applied and disclosed, when material. Factors an entity needs to consider when determining the accounting policy for legal fees include whether the policy provides for meaningful presentation of the balance sheet and income statement, whether the policy improves comparability among entities that may have ongoing litigation exposure, and whether the accrual of legal fees is representative of the way in which the entity manages its litigation exposure (where resolution and legal defense costs are so directly interrelated that they are inseparable from the overall liability determination). Whether expensed as incurred or accrued in advance, litigation expense should generally be classified as an operating expense in the statement of operations.

2.3.2.6 Measurement Date for Stock Issued in Settlement of Litigation

A company may settle a legal action by issuing shares of its stock to the counterparty. The parties may reach a preliminary agreement, subject to court approval, on the number of shares to be issued. The issuing entity records an estimated liability on the basis of the then fair value of the stock whose issuance is probable. Under an agreement that is subject to court approval, the court approval date is the appropriate measurement date for stock issued in settlement of litigation. The total expense recognized in connection with the final settlement of a lawsuit should be measured on the court approval date.
The court’s approval of a settlement is a substantive event rather than an administrative matter or a formality. This view is derived by analogy to the definition of the grant date provided in ASC 718-20, which indicates that for plans that are subject to shareholder approval, a measurement date for a stock award is the date when shareholder approval is obtained. The approval of a legal settlement by a court that serves as the ultimate judge of fairness (i.e., approval is not perfunctory) represents the final “future event” that gave rise to the original characterization of the loss as a contingency under ASC 450-20. Accordingly, when the future event occurs, the liability is adjusted to the final cost.

Example 2-11

**Litigation Settlement in Shares Subject to Court Approval**

Entities A and Z are parties to ongoing litigation that is subject to a court-mandated mediation process. Once the mediator, A, and Z agree on a settlement amount, final court approval is needed for the settlement to be finalized. On March 3, 20X9, as a result of the mediation process, A agrees to issue 200,000 shares to Z to settle the litigation, subject to the court’s final approval.

Before March 3, 20X9, A had previously recognized a contingent liability related to the litigation for $1.75 million because A had concluded that it was probable that a loss had been incurred and $1.75 million was its estimate for the loss. On the agreement date, March 3, 20X9, the fair value of the A’s shares was $10 per share and A adjusted its recognized liability to $2 million ($10 per share × 200,000 shares) by debiting expense and crediting contingent liability for $250,000.

On March 30, 20X9, the court approves the settlement agreement of 200,000 shares to be issued by A to Z. On the court approval date, the fair value of A’s shares was $11 per share. Entity A must recognize the incremental $200,000 (($11 per share − $10 per share) × 200,000 shares) loss in income at this time since the court approval was a substantive part of the litigation settlement. The measurement date for the ultimate liability is the court approval date of March 30, 20X9. Upon issuance of its shares, A should debit the total contingent liability recognized of $2.2 million, with a corresponding credit to equity.

**2.3.2.7 Recognition of Annual Bonus Plan Liabilities**

Many companies use cash bonus plans to compensate employees. Annual bonus plans may be based on specific formulas and performance targets or may be at the discretion of management and the compensation committee of the company’s board of directors. In some plans, annual bonus amounts are determined after the end of a fiscal year and may not be determined until after the financial statements are issued. Bonuses also may be forfeited if an employee is terminated or resigns.

The recognition criteria of ASC 450-20 should be used to estimate the amount of a bonus whose payment is probable when the cash bonus plan is not subject to other applicable U.S. GAAP (such as ASC 718). If the amount of a bonus that will be achieved or granted is uncertain, a range should be computed under the guidance in ASC 450-20-30-1. If “no amount within the range is [considered] a better estimate than any other amount,” the low end of the range should be selected. Entities must carefully evaluate bonuses that are based on achievement of a target to determine whether such achievement is probable.
Once an entity has determined the amount of the probable bonus, it should recognize the amount over the service period. Recognizing compensation expense in this manner is analogous to recognizing expense in connection with stock-based compensation arrangements over the related service period as required under ASC 718. Under this model, the obligating event giving rise to the liability is considered the employee’s performance of service. Recognition of a bonus liability should not be delayed just because the bonus would not be paid if an employee were to terminate employment before the end of the service period. Rather, if a reliable estimate of employee turnover is possible, the entity may factor this estimate into the range of estimates when determining the probable liability. Any difference between the actual bonus paid and the amount accrued is considered a change in accounting estimate.

Example 2-12

**Employee Benefit Arrangements**

Company P is preparing its financial statements for the fiscal year ending December 31, 20X4. On January 2, 20X4, P initiates an incentive compensation plan for its senior executives. Under the plan, each executive is allocated a portion of a pool of 500 units. The value of each unit will be determined as of the plan measurement date (December 31, 20X5) in accordance with a plan formula that uses as its basis the difference between P’s net income in 20X5 and P’s net income in 20X4. On December 31, 20X6, each executive who has remained with P in uninterrupted service during the period from January 1, 20X4, through December 31, 20X6, will receive a cash bonus based on this calculation of unit value.

Although P annually prepares a projection of its net income for the year, there is uncertainty about whether the amount will ultimately be attained since the company has failed to achieve its targets in recent years. Management has calculated that if P meets its forecasted level of net income in fiscal 20X5, the bonus (payable at the end of 20X6 under the plan) could be as high as $8 million.

Company P should use all available information to reasonably estimate its liability for the cash bonus plan and accrue in fiscal 20X4 the percentage of the liability that is related to the 20X4 service period. When considering its forecast of net income for fiscal 20X5, P should take into account any recent trends or developments and the accuracy of its prior projections.

The probable percentage of the liability that is related to the expired service period, which is estimated by management to be 33.3 percent (calculated on the basis of one of three fiscal years for which the executive is required to have been employed), should be accrued as of December 31, 20X4. The remaining 66.7 percent should be accrued over the following two years. The amount of the probable bonus should be reconsidered in each subsequent reporting period.

In accordance with ASC 450-20-30-1, if P determines that the range of loss could be from $1 million to $8 million and no amount within the range is considered a better estimate than any other amount, it would be appropriate for P to accrue a $1 million liability.

However, since it is reasonably possible that a liability greater than $1 million has been incurred, ASC 450-20-50-4 requires P to disclose in its fiscal 20X4 financial statements a complete description of the plan and an estimate of the possible loss or range of loss or a statement that such an estimate cannot be made.

### 2.3.2.7.1 Interim Considerations

When allocating annual bonuses to interim periods, entities should consider the guidance in ASC 270-10-45-8 through 45-10. Costs and expenses should be allocated to interim periods so that each interim period bears a reasonable portion of the annual expense. Each quarter, entities should determine the amount of bonus for which achievement is probable in accordance with ASC 450-20-25-2 and recognize this amount so that each interim period bears a reasonable portion of the annual expense. Entities must exercise judgment in determining the appropriate allocation method, and they should apply the selected method consistently in each reporting period.
For example, an entity may have a discretionary bonus plan that provides for the payment of annual bonuses to certain employees on the basis of the entity's overall achievement of specific key financial metrics. In accordance with ASC 450-20, in each reporting period the entity would estimate the amount of bonus for which payment is probable and recognize an amount that bears a reasonable portion of the annual expense. The entity may conclude that as a result of recognizing the bonus on a straight-line basis over the performance period, each interim period bears a reasonable portion of the annual bonus expense. Alternatively, the entity may conclude that each interim period bears a reasonable portion of the annual bonus as a result of recognizing the annual bonus on the basis of the entity's proportionate achievement of specific key financial metrics. The entity would apply the method used consistently in each reporting period.

2.3.2.8 Injury or Damage Caused by Products Sold

Life sciences entities may be subject to recalls on their products (e.g., medical devices, pharmaceutical drugs). While some product recalls are voluntary (e.g., the drug manufacturer has chosen to take the drug off the shelves or notified consumers and doctors to stop using the product or return it), other recalls may be required by law or a regulator (e.g., the FDA).

In a situation whereby a company is not otherwise required by law or a regulator to initiate a product recall, the obligating event triggering liability recognition for the costs (i.e., repurchasing inventory) associated with a voluntary product recall would generally be the announcement of the recall. Except as provided for in a warranty arrangement, a company has no legal obligation or duty associated with product design or manufacturing defects after the product is sold. Because there is no legal obligation, there is no event that gives rise to a probable loss until a recall is announced voluntarily.

Alternatively, there could be a situation in which a company concludes that on the basis of current laws or regulations, it is probable that such a law or regulation will require the company to initiate a product recall as a result of adverse events or conditions associated with the product in the distribution channel (i.e., inventory that has been sold but yet to be consumed). In such a situation, the obligating event triggering liability recognition for the costs of the recall is the existence of the current law or regulation, and liability recognition for the estimated costs of the recall would generally be required once a company has concluded that it is probable that such a law or regulation will require a recall and the associated costs can be reasonably estimated. Further, such a conclusion could be reached before formal notification by a regulator that a recall will be mandated.

The above discussion regarding the obligation associated with a product recall does not take into account those situations in which a product may have caused harm or damage that could result in potential loss against a company. In such a situation, a loss contingency would be recorded once the loss is deemed probable and reasonably estimable in accordance with ASC 450-20-25-2.
Unless other authoritative literature requires costs to fulfill product recalls to be classified in a particular manner (i.e., the guidance in ASC 606 on consideration for a product returned from a customer), they should be classified as operating costs in the financial statements because they result from an inherent business risk.

**Example 2-13**

**Voluntary Recall Initiated by the Company**

Big Pharma develops and manufactures health care products, including medicines and vaccines to advance wellness, prevention, treatments, and cures. In May and June, Big Pharma distributes 25,000 bottles of a pediatric drug to various distributors. The drug is commonly used to reduce fever and relieve symptoms from conditions such as the flu and a common head cold.

In August, Big Pharma discovers that 8,500 of the bottles, specifically the 3 ounce cherry flavor, were distributed with the incorrect dosage cups. The dosage instruction provides dosing in teaspoons, while the dosage cups included in the packaging were labeled in tablespoons. Since 1 tablespoon contains 3 teaspoons, Big Pharma is concerned that the usage of the tablespoon dosage cups could result in dangerous overdoses if the cups' labeling was overlooked.

There is no law or regulation in place requiring Big Pharma to recall the drugs for including the incorrect dosage cups. In addition, there have been no consumer lawsuits brought against Big Pharma for shipping the 3 ounce bottles of the drug in the cherry flavor with incorrect dosage cups. However, Big Pharma weighs the potential overdose risks of consumers' overlooking the measurement metric on the dosage cup and decides to voluntarily recall the product. On August 11, 20X9, Big Pharma announces the recall for the 8,500 affected bottles and will recognize a liability upon announcement of the recall for the estimated costs to remove and replace the bottles from distributors and retail stores and notify consumers. Because Big Pharma was not otherwise required by law to initiate the product recall, the obligating event triggering the liability recognition is the announcement of the recall on August 11, 20X9. Any liability related to potential consumer lawsuits would be accounted for according to ASC 450-20, separately from the costs Big Pharma expects to incur related to the recall.

**Example 2-14**

**Recall Required by a Regulator**

Mattress Store designs and sells mattresses for sale through various online retail Web sites. Mattress Store recently developed a new sleeper sofa available in various sizes, including twin, queen, and king, in a color choice of grey, blue, and black. Mattress Store begins selling the sleeper sofa in January. In March, Mattress Store discovers the blue sleeper sofa is not in compliance with the mandatory federal flammability standard for mattresses and therefore poses a fire hazard. Although there have been no incidences reported or litigation brought against Mattress Store, the sleeper sofa is in violation of a federal law, and if it were reported to the U.S. Consumer Product Safety Commission, the commission would mandate a product recall and bar Mattress Store from selling the sleeper sofa. Because Mattress Store is in violation of a federal law, it announces a product recall in April to refund consumers who bought the sleeper sofa and reacquire all sold inventory.

Although the recall is announced in April and the regulator has not yet provided formal notification of a mandated recall for the sleeper sofa, Mattress Store had determined in March that it was probable that the U.S. Consumer Product Safety Commission would require the company to recall the sleeper sofa upon discovery of the violation of flammability standards. Further, Mattress Store concluded that sufficient information was available in March to make a reasonable estimate for the cost of the recall. Accordingly, Mattress Store records a liability for the product recall in March, before the April recall announcement or a regulator-mandated recall. Any liability related to potential consumer lawsuits would be accounted for according to ASC 450-20, separately from the costs Mattress Store expects to incur related to the recall.
2.3.3 Threat of Expropriation

ASC 450-20-55-9 states that “[t]he threat of expropriation of assets is a contingency (as defined) because of the uncertainty about its outcome and effect.” The guidance requires recognition of a loss from threat of expropriation of assets only if (1) expropriation is imminent and (2) consideration received for the expropriated assets will be less than the carrying amount, resulting in a loss. With respect to (1), “[i]mminence may be indicated, for example, by public or private declarations of intent by a government to expropriate assets of the entity or actual expropriation of assets of other entities.” With respect to (2), an entity would recognize a loss only when the consideration received is less than the carrying value of the expropriated asset. The condition in ASC 450-20-25-2(b) requires that accrual be made only if the amount of loss can be reasonably estimated. In accordance with ASC 450-20-55-9, “[i]f the conditions for accrual are not met,” the entity should make appropriate disclosures “if there is at least a reasonable possibility that an asset has been impaired” (see Section 2.8 for a discussion of disclosure requirements).

2.3.4 Parent’s Accounting for Guarantee of Subsidiary Debt

In a parent-subsidiary relationship, a parent may enter into a guarantee contract for the repayment of debt issued by its subsidiaries to a third party. Such a guarantee contract would obligate the parent to make payments to the lenders upon inability to do so by its subsidiaries. ASC 460-10 excludes a “parent’s guarantee of its subsidiary’s debt to a third party” from the recognition and initial measurement provisions of ASC 460. However, a parent is still required to consider the guidance in ASC 450-20 in determining whether it needs to record in its stand-alone, parent-only financial statements an estimated loss from a loss contingency for its guarantee of its subsidiary’s debt under ASC 450-20-25.

Example 2-15

Determining When to Recognize a Liability for the Guarantee of a Subsidiary’s Debt

On October 15, 20X4, Entity A purchases a controlling interest in Investee B and consolidates B in A’s consolidated financial statements. Entity A also guarantees B’s third-party debt of $1 million. In A’s consolidated financial statements, the entire $1 million of debt is recognized in its financial statement owing to A’s controlling interest in B.

In preparing its stand-alone, parent-only financial statements, A continually reassesses the guidance in ASC 450 in each reporting period. On December 31, 20X5, A determines that (1) it is probable that B will default on its debt in the future and (2) the amount of the loss can be reasonably estimated. In accordance with ASC 450-20-25-2, A should recognize a liability in its stand-alone, parent-only financial statements for its probable payment of B’s debt. The amount of the liability is determined by identifying the best estimate, or minimum amount within a range, as indicated under ASC 450-20-30-1.

Connecting the Dots

In a scenario in which an investment fund, in accordance with ASC 946-810, does not consolidate a noninvestment company investee for which it has a controlling interest, it nonetheless would apply the scope exception in ASC 460-10-25-1(g) for “[a] parent’s guarantee of its subsidiary’s debt to a third party” with respect to a guarantee issued by the investment fund for a debt that the noninvestment company investee owes to a third party. This is because notwithstanding the fact that the investment fund has not consolidated the noninvestment company investee, the nature of their relationship is that between a parent and its subsidiary. In this case, the investment fund should consider the guidance in ASC 450-20-25 when determining whether a loss contingency should be recorded for the guarantee of its investee’s debt.
2.4 Measurement

ASC 450-20

30-1 If some amount within a range of loss appears at the time to be a better estimate than any other amount within the range, that amount shall be accrued. When no amount within the range is a better estimate than any other amount, however, the minimum amount in the range shall be accrued. Even though the minimum amount in the range is not necessarily the amount of loss that will be ultimately determined, it is not likely that the ultimate loss will be less than the minimum amount. Examples 1–2 (see paragraphs 450-20-55-18 through 55-35) illustrate the application of these initial measurement standards.

Once the recognition criteria under ASC 450-20-25-2 are met, entities should accrue the 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. See Section 2.3.2.3 for illustrative examples of the application of ASC 450-20-30-1.

The estimate of a contingent liability should be made independently from any possible claim for recovery (see Chapter 4 for the accounting for loss recoveries). For example, entities may enter into certain insurance contracts to protect themselves from a litigation loss, but the presence of insurance does not relieve the entity from being the primary obligor.

2.4.1 Offer to Settle Litigation

Entities will often make offers to settle litigation. We believe that an offer by management to settle litigation creates a presumption that it is probable that a liability has been incurred. The settlement offer establishes a low end of the range under ASC 450-20-30-1, resulting in accrual of a liability. Withdrawal of a settlement offer before acceptance and before issuance of the financial statements generally would not change this conclusion since the existence of the offer provides evidence that the company may be willing to settle the litigation for at least that amount.

The presumption that a settlement offer triggers accrual of a liability and the establishment of a low end of the range is generally considered to be a high hurdle to overcome, and its rebuttal should be based on persuasive evidence. The evidence should substantiate that it is not probable that the offer will be accepted. In addition, the evidence should substantiate that it is not probable that further negotiations will lead to an out-of-court settlement for which the entity will owe payment to the counterparty. In certain circumstances, an out-of-court settlement may be the only realistic litigation strategy because a trial is deemed too risky. In such circumstances, the extension of an offer to settle out of court is a strong indicator that the entity will ultimately settle with the counterparty for an equal or greater amount. Accordingly, when an offer has been extended to settle out of court, it must be at least reasonably possible that the litigation will be settled via court proceedings or arbitration in an amount that could be higher or lower than the offer. A company that believes that the presumption has been overcome should consider consulting with its accounting advisers.
Connecting the Dots

An entity should carefully consider all facts and circumstances when assessing whether an “offer” has been extended to settle litigation. Questions may arise about when a formal offer has been made versus parties’ exploring potential settlement amounts. In making this determination, entities should consider whether approval from additional members of management or the board of directors is required to constitute a formal offer to settle. Further, the evidence available to substantiate that an offer does not constitute the low end of the range is often subjective, and care should be taken when the entity is evaluating whether the presumption can be overcome.

Example 2-16

**Offer to Settle Litigation**

Company X is in the medical device business and has been named as the defendant in a lawsuit alleging personal injury resulting from use of one of its surgical devices. After year-end but before issuance of the financial statements, X offers to settle the litigation for $10 million. The plaintiff has not responded to the offer, and X believes that if the matter ultimately goes to trial, the outcome is uncertain. Company X’s management believes that the parties are still far from deciding on a settlement value, and therefore the plaintiff is not likely to accept the offer. However, given the significant exposure X faces in a trial, it is probable that the matter will eventually be settled.

The offer to settle is significant objective evidence that it is probable that a liability has been incurred as of the date of the financial statements and that the amount of the offer constitutes the minimum amount in the range and should be accrued in the financial statements in accordance with ASC 450-20-30-1. Company X must also disclose any additional reasonably possible exposure to loss in its financial statements if the disclosure requirements in ASC 450-20-50-3 are met.

2.4.2 Comparison of the “Probability-Based” and “Expected Value Cash Flow” Accounting Models

A question may be raised if the liability measurement guidance in FASB Concepts Statement 7 should be applied to the measurement of contingent liabilities recognized in accordance with ASC 450-20. The expected value cash flow model in Concepts Statement 7 is different from the probability-based accounting model in ASC 450-20-25-2. Although the expected value cash flow model in Concepts Statement 7 is probability weighted, it addresses the measurement of expected cash flows that may incorporate events into its measurement that are not considered probable from a loss contingency perspective under ASC 450-20. Alternatively, the probability-based accounting model in ASC 450-20-25-2 addresses the recognition of an uncertain event. Differences of this nature are further discussed in paragraph B35 of the Basis for Conclusions of FASB Statement 143 (superseded), which states, in part:

Statement 5 and Concepts Statement 7 deal with uncertainty in different ways. Statement 5 deals with uncertainty about whether a loss has been incurred by setting forth criteria to determine when to recognize a loss contingency. Concepts Statement 7, on the other hand, addresses measurement of liabilities and provides a measurement technique to deal with uncertainty about the amount and timing of the future cash flows necessary to settle the liability. Because of the Board's decision to incorporate probability into the measurement of an asset retirement obligation, the guidance in Statement 5 and FASB Interpretation No. 14, Reasonable Estimation of the Amount of a Loss, is not applicable.

Therefore, we do not believe that use of the measurement guidance in Concepts Statement 7 is appropriate for the measurement of a contingent liability in accordance with ASC 450-20.
2.4.3 Application of Present-Value Techniques to the Measurement of a Contingent Liability

The objective of the recognition and measurement loss contingency guidance is to accrue a liability that will equal or approximate the ultimate settlement amount when the uncertainty related to the loss contingency is ultimately resolved. In limited instances, it may be appropriate to use present-value techniques to discount a contingent liability recognized in accordance with ASC 450-20-25-2. Generally, discounting of contingent liabilities is not appropriate unless both the timing and amounts of future cash flows are fixed or reliably determinable on the basis of objective and verifiable information.

The application of discounting to liabilities recognized in accordance with ASC 450-20-25-2 differs from the present-value-based measurements required by other accounting standards. The sections below provide additional guidance about the application of present-value techniques.

2.4.3.1 Applicable Guidance to Discounting Contingent Liabilities

ASC 450-20 does not provide explicit guidance on whether it is appropriate to discount a contingent liability that is within its scope. Although ASC 410-30 specifically addresses environmental remediation liabilities, it may be useful in an entity’s evaluation of whether discounting is appropriate for similar loss contingencies. ASC 410-30-35-12 states that the “measurement of the liability, or of a component of the liability, may be discounted to reflect the time value of money if the aggregate amount of the liability or component and the amount and timing of cash payments for the liability or component are fixed or reliably determinable.”

The SEC has provided guidance on discounting claims liabilities related to short-duration insurance contracts. The SEC staff’s interpretive response to Question 1 of SAB Topic 5.N (codified in ASC 944-20-S99-1) states, in part:

- Discounting liabilities with respect to settled claims under the following circumstances:
  1. The payment pattern and ultimate cost are fixed and determinable on an individual claim basis, and
  2. The discount rate used is reasonable on the facts and circumstances applicable to the registrant at the time the claims are settled.

By analogy to the above guidance, discounting of a contingent liability is permitted, but not required, if both the timing and amounts of future cash flows are fixed or reliably determinable. However, because the timing and amounts of future cash flows of many contingent liabilities are inherently subjective, it is often difficult for an entity to meet the criteria for discounting a contingent liability (e.g., in the early phases of litigation and environmental remediation efforts).

The SEC staff has indicated that it continues to scrutinize compliance with this requirement and that the notion of “reliably determinable” is inconsistent with a disclosure that additional losses beyond amounts accrued are reasonably possible. Similarly, if the low end of a range of possible losses were accrued under the guidance in ASC 450-20-30-1, discounting would not be appropriate because the aggregate obligation is not fixed or reliably determinable.
SEC Considerations

The SEC staff’s interpretive response to Question 1 of SAB Topic 5.Y (codified in ASC 450-20-599-1) states that if a contingent liability is recognized on a discounted basis, the “notes to the financial statements should, at a minimum, include disclosures of the discount rate used, the expected aggregate undiscounted amount, expected payments for each of the five succeeding years and the aggregate amount thereafter, and a reconciliation of the expected aggregate undiscounted amount to amounts recognized in the statements of financial position.”

By analogy to ASC 410-30-35-10 and 35-11, if a contingent liability is discounted, any related asset recognized as a result of a third-party recovery also should be discounted.

In addition, ASC 835-30 provides guidance on discounting payables. ASC 835-30-15-2 applies to “payables that represent . . . contractual obligations to pay money on fixed or determinable dates, whether or not there is any stated provision for interest.” However, ASC 835-30-15-3(a) specifically exempts from present-value techniques those “payables arising from transactions with customers or suppliers in the normal course of business that are due in customary trade terms not exceeding approximately one year.”

Example 2-17

Discounted Environmental Obligation

Company C is subject to environmental obligations in connection with groundwater contamination at several of its domestic plants. Company C has substantially satisfied all initial remediation costs but expects to incur charges for monitoring costs on an ongoing basis at several plant sites. The exact term of the monitoring activities is not specified in the remediation agreement approved by the Environmental Protection Agency, but C expects that, on the basis of past experience and internal estimates, the likely term for such monitoring activities is 30 years. Company C has estimated the costs for these monitoring activities each year by adjusting current annual maintenance costs at each plant for inflation and productivity improvements. It has proposed to use an appropriate rate to discount this future obligation.

The absence of a definitive required post-remediation monitoring term does not preclude discounting this element of an environmental remediation liability. Similarly, the need to estimate inflation, productivity improvements, or both does not, in and of itself, lead to the conclusion that the cash flows are not reliably determinable. A rate appropriately blending such factors with the discount rate would be reasonable in this circumstance.

2.4.3.2 Selection of an Appropriate Discount Rate

If an entity has determined that a contingent liability qualifies for discounting, consideration should be given to the appropriate discount rate. ASC 835-30 does not dictate the interest rate that should be used to discount a liability. However, ASC 835-30-10-1 and ASC 835-30-25-13 provide the following guidance:

10-1 The objective of the guidance in this Subtopic is to approximate the rate for a note that would have resulted if an independent borrower and an independent lender had negotiated a similar transaction under comparable terms and conditions with the option to pay the cash price upon purchase or to give a note for the amount of the purchase that bears the prevailing rate of interest to maturity.

25-13 The selection of a rate may be affected by many considerations. For instance, where applicable, the choice of a rate may be influenced by the following:

a. An approximation of the prevailing market rates for the source of credit that would provide a market for sale or assignment of the note

b. The prime or higher rate for notes that are discounted with banks, giving due weight to the credit standing of the maker
c. Published market rates for similar-quality bonds

d. Current rates for debentures with substantially identical terms and risks that are traded in open markets

e. The current rate charged by investors for first or second mortgage loans on similar property.

SEC Considerations

The SEC staff's interpretive response to Question 1 of SAB Topic 5.Y states that the discount “rate used to discount the cash payments should be the rate that will produce an amount at which the . . . liability could be settled in an arm's-length transaction with a third party. . . . [T]he discount rate used to discount the cash payments should not exceed the interest rate on monetary assets that are essentially risk free and have maturities comparable to that of the . . . liability” (footnote omitted). Discount rates based on the registrant’s incremental cost of capital, incremental borrowing rate, or investment portfolio yields are not appropriate. In most cases, it will be difficult for an SEC registrant to justify a discount rate higher than the risk-free rate because market transactions are rarely available. This guidance should be applied by SEC registrants in their selection of an appropriate discount rate for all contingent liabilities.

Non-SEC registrants may also consider the preceding guidance in SAB Topic 5.Y. However, there is diversity in practice among non-SEC registrants, and selection of a discount rate for contingent liabilities based on a measure other than the risk-free rate (e.g., high-quality fixed-income debt securities) may also be acceptable.

2.4.3.3 Accounting for Subsequent Changes in the Discount Rate

Entities that elect to discount contingent liabilities must consider the impact of changing discount rates when adjusting the amount of the liability as of each balance sheet date. Entities should select their discounting approach as part of their accounting policies to be applied consistently to all contingencies.

Two methods are used in practice to account for the change in a liability attributable to fluctuations in the discount rate. One alternative, the immediate recognition approach, is to remeasure the liability at the current discount rate and recognize any increase or decrease in the liability through earnings.

Alternatively, a “lock-in” approach may be used. Under the lock-in approach, an entity would effectively create a separate layer of liability each time the obligation is remeasured. The lock-in principle is discussed in AICPA Issues Paper The Use of Discounting in Financial Reporting for Monetary Items With Uncertain Terms Other Than Those Covered by Existing Authoritative Literature. Issue 4B of this paper concludes that “changes in the discount rate should not be recognized in the financial statements and the original discount rate should be used in all subsequent periods (that is, locked in).” The conclusion also indicates that “[i]f the lock-in concept is adopted, . . . there are situations where a discount rate other than the rate used in the initial recording of the item may be used.” For example, if changes in circumstances subsequently resulted in an upward adjustment to the liability, the incremental liability would be recorded at a current discount rate rather than the discount rate used to measure the original liability.

2.4.3.4 Change in Accounting Policy Related to Discounting of Contingent Liabilities

For those contingent liabilities that qualify for discounting, the election to discount is a matter of accounting policy that should be consistently applied and disclosed. An entity contemplating discounting a contingent liability accounted for under ASC 450 should consider ASC 250-10-45-12 to determine whether discounting would be considered a voluntary change in accounting principle that is preferable.
If the entity concludes that discounting a contingent liability is an allowable but not preferred method, a change in accounting principle is not allowed. A voluntary change in accounting principle would be accounted for in accordance with ASC 250-10.

On the other hand, if a change in the entity-specific facts and circumstances regarding the predictability in the timing and amount of the liability payments results in the contingent liability's no longer qualifying for discounting, a change to measuring the liability on an undiscounted basis would not constitute a voluntary change in accounting principle but rather would be accounted for as a change in accounting estimate in accordance with ASC 250-10.

### 2.5 Consideration of Inflation

A topic closely related to the discounting of liabilities is the consideration of inflation when liabilities are measured. Contingent liabilities may ultimately be settled many years after the current reporting period. It is appropriate for an entity to consider the impact of inflation when measuring a contingent liability, irrespective of whether the liability qualifies to be discounted and ultimately is discounted, unless it is impracticable for the entity to do so. Although ASC 450-20 does not provide guidance on whether an entity should consider the impact of inflation when measuring a contingent liability, an entity should consider the guidance in ASC 410-20 and ASC 410-30 on asset retirement obligations and environmental obligations, respectively, which may be useful for evaluating whether the impact of inflation should be considered when other types of contingent liabilities are measured. Specifically, ASC 410-20-55-13(b) and ASC 410-30-30-17 require an adjustment for inflation unless it is impracticable. See also [Section 3.3](#) of Deloitte's [*A Roadmap to Accounting for Environmental Obligations and Asset Retirement Obligations*].

### 2.6 Remeasurement and Derecognition of a Contingent Liability

#### 2.6.1 Remeasurement

Unlike a contractual or legal liability (discussed in [Section 2.2.4](#)), whose measurement is established on the basis of the contract or law, the initial and subsequent measurement of a contingent liability in accordance with ASC 450-20-30 may involve a number of judgments, including those discussed in [Section 2.4](#). These uncertainties may necessitate the continual evaluation and remeasurement of the contingent liability as new information becomes available. Such remeasurement in accordance with ASC 450-20-30 could produce an estimated amount that is lower or higher when compared with the amount previously recognized, thereby resulting in a reduction or increase, respectively, of the contingent liability. If the new information indicates a reduction of the previously recognized liability, such a reduction should not be viewed as tantamount to derecognition of the contingent liability. That is, the remeasurement of a previously recognized contingent liability on the basis of the receipt of new information that supports a lower estimated probable loss should not be viewed as a partial derecognition of a loss whose occurrence was and continues to be considered probable; rather, it should be viewed and accounted for as a change in estimate in accordance with ASC 250.

There may also be circumstances in which sufficient and reliable data no longer are available to support an estimate that was previously made for a contingent liability whose occurrence remains probable. For example, an entity may recognize a contingent liability on the basis of an actuarial analysis of historical loss data, but the availability of settlement data during recent periods may have declined significantly because of external factors. The decrease in the availability of recent loss data may have diminished the entity's ability to reasonably estimate the amount of the previously recognized contingent liability. However, the entity may believe that it is still probable that one or more future events will confirm that a liability has been incurred. Therefore, while the entity concludes that a loss associated with the contingent liability remains probable, it will nonetheless need to assess whether the previously accrued
amount continues to represent an appropriate estimate or if another estimate should be made on the basis of the recent circumstances surrounding the availability of recent data, which could result in a reduction, or even a complete reversal, of the previously recognized loss. We believe that when the entity is evaluating whether it is appropriate to remeasure a contingent liability in such a circumstance, the entity should carefully support remeasurement with compelling and sufficiently reliable evidence that provides a reasonable basis for the entity to conclude that there has been a change in its previous judgment regarding the amount of the estimated loss to accrue. Further, clear disclosure of the change in facts and circumstances should be considered.

2.6.2 Derecognition When Settlement Is No Longer Considered Probable

As noted in Section 2.3, a contingency that fails to meet one or both of the two criteria in ASC 450-20-25-2 does not reach the threshold for recognition in the financial statements. However, when those criteria have been met, questions may arise about when it is appropriate for an entity to derecognize a previously recognized contingent liability when settlement is no longer considered probable.

For example, an entity may recognize a contingent liability related to the probable incurrence of a loss because of pending litigation. Subsequently and on the basis of the facts and circumstances surrounding the litigation, the entity may conclude that such a loss is no longer considered probable, even though the matter is not subject to legal release or statute of limitations given the noncontractual nature of the contingency. In such a scenario, derecognition of the contingent liability would be reasonable given the conclusion that a loss is no longer considered probable. However, the assessment of whether a contingency is likely to occur often involves considerable subjectivity. In those cases, it may be prudent to reduce or reverse an existing accrual only when the evidence is reasonably clear or compelling that a loss is no longer considered probable. When determining the sufficiency of evidence to support derecognition, entities should consider the potential that derecognition in certain circumstances could be misleading to the users of the financial statements because it could inappropriately communicate that the liability has been extinguished when the contingency still exists. Clear disclosure of the change in the accrual and the underlying facts and circumstances should be provided.

The following example illustrates a scenario in which derecognition of a contingent liability may be appropriate when settlement is no longer considered probable:

Example 2-18

Derecognition of a Contingent Liability

Company S is a defendant in a lawsuit filed in 20X2 by a competitor, Company Z. In 20X4, a jury finds in favor of Z and awards damages of $10 million. Company S’s management determines that it is probable that a liability has been incurred despite its intent to appeal the verdict, and S recognizes a loss in the 20X4 financial statements. In December 20X8, the appeals court sets aside the previous jury verdict and remands the case back to the lower court for another trial. Company S has obtained an opinion from its legal counsel that says S has meritorious defenses and that the outcome of the new trial is uncertain after taking into account the reasons for the findings of the appeals court. Company S therefore derecognizes the previously recognized contingent liability given that it has determined that the evidence supported a conclusion that it was no longer probable that it would incur a loss in accordance with the litigation.

Company S should ensure that it has properly disclosed the change in facts and circumstances in the financial statements. In addition, although this illustrative example is provided to present the analysis an entity may undertake to determine when to derecognize a contingent liability, as a practical matter, entities may often find it challenging to obtain sufficiently compelling evidence to support a conclusion to reverse some or all of an existing contingent liability before complete elimination of the uncertainty. Company S will need to consider the totality of evidence available, including counsel’s views.
2.7 Balance Sheet Classification

The balance sheet classification of an accrued contingent liability should be based on the period in which the entity expects the contingency to be settled. A liability should be classified as short term if the liability is expected to be settled within one year or less of the balance sheet date (or longer if the entity’s operating cycle is greater than one year). Otherwise, the liability should be classified as long term.

2.8 Disclosure Considerations

2.8.1 Disclosure Considerations Under ASC 450-20 and ASC 275

Disclosures of loss contingencies required under ASC 450-20 are intended to provide the readers of financial statements with an understanding of risks and how they could potentially affect the financial statements.

Accrual accounting requires that estimates be made in current-period financial statements to reflect current events and transactions, the effects of which may not be precisely determinable until some future period. The final results may not match original expectations. Uncertainty about the outcome of future events is inherent in economics, and that fact should be understood when reading reports on economic activities, such as published financial statements. A business, to a great extent, is a function of the environment in which it operates. Thus, it can be affected by changing social, political, and economic factors. In addition, every entity is subject to uncertain future events that may affect the entity or the industry in which it operates. These uncertainties may or may not be considered contingencies as defined by ASC 450-10-20. As a result, the disclosures required by ASC 275-10-50 supplement, and, in many cases, overlap the disclosures required by ASC 450-20-50.

Not all uncertainties inherent in the accounting process give rise to contingencies as that word is used in ASC 450. Estimates are required in financial statements for many of an entity’s ongoing and recurring activities. The fact that an estimate is involved does not by itself constitute the type of uncertainty referred to in the definition of a contingency in ASC 450-10-20. For example, the fact that estimates are used to allocate the known cost of a depreciable asset over the period of use by an entity does not make depreciation a contingency; the eventual expiration of the use of the asset is not uncertain. Thus, depreciation of assets is not a contingency as discussed in ASC 450-10-55-2, and depreciation should be accounted for as described in ASC 360-10-35. In addition, matters related to depreciation (e.g., recurring repairs, maintenance, and overhauls) are similarly outside the scope of ASC 450. Amounts owed for services received, such as advertising and utilities, are not contingencies even though the accrued amounts may have been estimated; there is nothing uncertain about the fact that those obligations have been incurred.

Nearly all financial statement amounts require some degree of estimation. For example, inventories measured by using any method other than LIFO or the retail inventory method are measured at the lower of cost or net realizable value, various accrued liabilities require estimation of services received or amounts due, and accounts payable are subject to future adjustment because of such possibilities as improper billing or inadequate product quality or performance. All of these amounts usually are subject to reasonable estimation. However, many lawsuits that may create a material liability are not recorded because one or both conditions for recognition of a contingent liability are not met; they are nonetheless disclosed to the extent that a loss is reasonably possible.

Neither ASC 450-20 nor any other example of authoritative literature contains definitive guidelines on measuring the difference between estimates that are affected by uncertainty that can be estimated reasonably and those that cannot be estimated reasonably. Although estimates generally include some level of uncertainty, they are not necessarily loss contingencies. Thus, estimates regarding events in the
normal course of business have frequently been included in the financial statements without specific
disclosure since ASC 450-20-50 requires disclosure of only contingencies. ASC 275-10-50 extends
disclosure requirements to numerous risks and uncertainties, many of which are not considered
contingencies.

**ASC 450-20**

**Accruals for Loss Contingencies**

50-1 Disclosure of the nature of an accrual made pursuant to the provisions of paragraph 450-20-25-2, and in
some circumstances the amount accrued, may be necessary for the financial statements not to be misleading.
Terminology used shall be descriptive of the nature of the accrual, such as estimated liability or liability of an
estimated amount. The term reserve shall not be used for an accrual made pursuant to paragraph 450-20-
25-2; that term is limited to an amount of unidentified or unsegregated assets held or retained for a specific
purpose. Examples 1 (see paragraph 450-20-55-18) and 2, Cases A, B, and D (see paragraphs 450-20-55-23,
450-20-55-27, and 450-20-55-32) illustrate the application of these disclosure standards.

50-2 If the criteria in paragraph 275-10-50-8 are met, paragraph 275-10-50-9 requires disclosure of an
indication that it is at least reasonably possible that a change in an entity's estimate of its probable liability
could occur in the near term. Example 3 (see paragraph 450-20-55-36) illustrates this disclosure for an entity
involved in litigation.

**Unrecognized Contingencies**

50-2A The disclosures required by paragraphs 450-20-50-3 through 50-6 do not apply to loss contingencies
arising from an entity's recurring estimation of its allowance for credit losses. (See paragraph 310-10-50-21.)

**Pending Content (Transition Guidance: ASC 326-10-65-1)**

50-3 Disclosure of the contingency shall be made if there is at least a reasonable possibility that a loss or an
additional loss may have been incurred and either of the following conditions exists:

a. An accrual is not made for a loss contingency because any of the conditions in paragraph 450-20-25-2
are not met.

b. An exposure to loss exists in excess of the amount accrued pursuant to the provisions of paragraph
450-20-30-1.

Examples 1–3 (see paragraphs 450-20-55-18 through 55-37) illustrate the application of these disclosure
standards.

50-4 The disclosure in the preceding paragraph shall include both of the following:

a. The nature of the contingency

b. An estimate of the possible loss or range of loss or a statement that such an estimate cannot be made.

50-5 Disclosure is preferable to accrual when a reasonable estimate of loss cannot be made. For example,
disclosure shall be made of any loss contingency that meets the condition in paragraph 450-20-25-2(a) but that
is not accrued because the amount of loss cannot be reasonably estimated (the condition in paragraph 450-20-
25-2(b)), Disclosure also shall be made of some loss contingencies that do not meet the condition in paragraph
450-20-25-2(a) — namely, those contingencies for which there is a reasonable possibility that a loss may have
been incurred even though information may not indicate that it is probable that an asset had been impaired or
a liability had been incurred at the date of the financial statements.
Chapter 2 — Loss Contingencies and Commitments

**ASC 450-20 (continued)**

50-6 Disclosure is not required of a loss contingency involving an unasserted claim or assessment if there has been no manifestation by a potential claimant of an awareness of a possible claim or assessment unless both of the following conditions are met:

a. It is considered probable that a claim will be asserted.

b. There is a reasonable possibility that the outcome will be unfavorable.

50-7 Disclosure of noninsured or underinsured risks is not required by this Subtopic. However, disclosure in appropriate circumstances is not discouraged.

**ASC 275-10**

50-7 Various Topics require disclosures about uncertainties addressed by those Topics. In particular, Subtopic 450-20 specifies disclosures to be made about contingencies that exist at the date of the financial statements. In addition to disclosures required by Topic 450 and other accounting Topics, this Subtopic requires disclosures regarding estimates used in the determination of the carrying amounts of assets or liabilities or in disclosure of gain or loss contingencies, as described below.

50-8 Disclosure regarding an estimate shall be made when known information available before the financial statements are issued or are available to be issued (as discussed in Section 855-10-25) indicates that both of the following criteria are met:

a. It is at least reasonably possible that the estimate of the effect on the financial statements of a condition, situation, or set of circumstances that existed at the date of the financial statements will change in the near term due to one or more future confirming events.

b. The effect of the change would be material to the financial statements.

50-9 The disclosure shall indicate the nature of the uncertainty and include an indication that it is at least reasonably possible that a change in the estimate will occur in the near term. If the estimate involves a loss contingency covered by Subtopic 450-20, the disclosure also shall include an estimate of the possible loss or range of loss, or state that such an estimate cannot be made. Disclosure of the factors that cause the estimate to be sensitive to change is encouraged but not required. The words reasonably possible need not be used in the disclosures required by this Subtopic.

50-11 This Subtopic’s disclosure requirements are separate from and do not change in any way the disclosure requirements or criteria of Topic 450; rather, the disclosures required under this Subtopic supplement the disclosures required under that Topic as follows:

a. If an estimate (including estimates that involve contingencies covered by Topic 450) meets the criteria for disclosure under paragraph 275-10-50-8, this Subtopic requires disclosure of an indication that it is at least reasonably possible that a change in the estimate will occur in the near term; Topic 450 does not distinguish between near-term and long-term contingencies.

b. An estimate that does not involve a contingency covered by Topic 450, such as estimates associated with long-term operating assets and amounts reported under profitable long-term contracts, may meet the criteria in paragraph 275-10-50-8. This Subtopic requires disclosure of the nature of the estimate and an indication that it is at least reasonably possible that a change in the estimate will occur in the near term.

50-12 If a loss contingency meets the criteria for disclosure under both Topic 450 and paragraph 275-10-50-8, this Subtopic requires disclosure that it is at least reasonably possible that future events confirming the fact of the loss or the change in the estimated amount of the loss will occur in the near term.
In addition to the primary disclosures required under ASC 450-20, ASC 275 requires certain additional disclosure requirements when it is reasonably possible that a change in estimate will occur in the near term. The disclosure requirements under ASC 450-20 and ASC 275 are summarized below.

<table>
<thead>
<tr>
<th>Possibility That a Loss Has Been Incurred</th>
<th>Ability to Estimate a Loss</th>
<th>Disclosure Requirements of ASC 450-20 and ASC 275</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reasonably possible</td>
<td>May or may not be reasonably estimable</td>
<td>Disclose all of the following:</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• “The nature of the contingency” (e.g., a description of the patent infringement). See ASC 450-20-50-4(a).</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• “An estimate of the possible loss or range of loss or a statement that such an estimate cannot be made.” See ASC 450-20-50-4(b).</td>
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<td></td>
<td>• A statement indicating that it is at least reasonably possible that the estimated amount of the loss will change in the near term if (1) “It is at least reasonably possible that the estimate . . . will change in the near term” and (2) “the effect of the change would be material.” See ASC 275-10-50-8.</td>
</tr>
<tr>
<td>Probable</td>
<td>Not reasonably estimable</td>
<td>Disclose both of the following:</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• “The nature of the contingency” (e.g., a description of the patent infringement). See ASC 450-20-50-4(a).</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• A statement that the amount of the loss cannot be reasonably estimated. See ASC 450-20-50-4(b).</td>
</tr>
<tr>
<td>Probable</td>
<td>Reasonably estimable</td>
<td>Disclose all of the following:</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• “The nature of the contingency” (e.g., a description of the patent infringement). “The term reserve shall not be used for an accrual made pursuant to paragraph 450-20-25-2; that term is limited to an amount of unidentified or unsegregated assets held or retained for a specific purpose.” See ASC 450-20-50-1 and ASC 450-20-50-4(a).</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• The total amount of the loss that has been recognized (if such disclosure is required to ensure that the financial statements are not misleading). See ASC 450-20-50-1.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• A statement indicating that it is at least reasonably possible that the estimated amount of the loss will change in the near term if (1) “It is at least reasonably possible that the estimate . . . will change in the near term” and (2) “the effect of the change would be material.” See ASC 275-10-50-8.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• The exposure to loss in excess of the amount accrued under ASC 45-20 if there is at least a reasonable possibility that such excess loss may have been incurred. The disclosure should include both of the following:</td>
</tr>
<tr>
<td></td>
<td></td>
<td>◦ “The nature of the contingency.”</td>
</tr>
<tr>
<td></td>
<td></td>
<td>◦ “An estimate of the possible loss or range of loss or a statement that such an estimate cannot be made.” See ASC 450-20-50-3 and 50-4.</td>
</tr>
<tr>
<td>Remote</td>
<td>Not reasonably estimable</td>
<td>No specific disclosure requirements related to remote contingencies; however, disclosures may be provided if their omission could cause the financial statements to be misleading.</td>
</tr>
</tbody>
</table>
Example 3 of ASC 450-20-55-36 illustrates the determination and disclosure of a range of estimates.

**ASC 450-20**

**Example 3: Illustrative Disclosure**

55-36 Entity A is the defendant in litigation involving a major competitor claiming patent infringement (Entity B). The suit claims damages of $200 million. Discovery has been completed, and Entity A is engaged in settlement discussions with the plaintiff. Entity A has made an offer of $5 million to settle the case, which offer was rejected by the plaintiff; the plaintiff has made an offer of $35 million to settle the case, which offer was rejected by Entity A. Based on the expressed willingness of the plaintiff to settle the case along with information revealed during discovery and the likely cost and risk to both sides of litigating, Entity A believes that it is probable the case will not come to trial. Accordingly, Entity A has determined that it is probable that it has some liability. Entity A’s reasonable estimate of this liability is a range between $10 million and $35 million, with no amount within that range a better estimate than any other amount; accordingly, $10 million was accrued.

55-37 Entity A provides the following disclosure in accordance with Section 450-20-50.

On March 15, 19X1, Entity B filed a suit against the company claiming patent infringement. While the company believes it has meritorious defenses against the suit, the ultimate resolution of the matter, which is expected to occur within one year, could result in a loss of up to $25 million in excess of the amount accrued.

**SEC Considerations**

ASC 450-20-50-4 requires disclosures about the nature of any material contingency, including the amounts that might be paid, if a loss is at least reasonably possible. In addition, SEC Regulation S-K, Item 303, requires discussion of items that might affect a company’s liquidity or financial position in the future, including contingent liabilities.

The SEC staff has consistently commented on and challenged registrants’ compliance with the disclosure requirements in ASC 450-20. For example, Scott Taub, deputy chief accountant in the SEC’s Office of the Chief Accountant, noted the following in a speech at the 2004 AICPA National Conference on Current SEC and PCAOB Developments:

Given [the requirement to record an accrual if payment is both probable and estimable and the requirement to disclose the nature of any material contingency, including the amounts that might be paid, if a loss is at least reasonably possible], the recording of a material accrual for a contingent liability related to an event that occurred several years before should not be the first disclosure regarding that contingency. Rather, disclosures regarding the nature of the contingency and the amounts at stake should, in most cases, have already been provided. Disclosures should discuss the nature of the contingency and the possible range of losses for any item where the maximum reasonably possible loss is material. Vague or overly broad disclosures that speak merely to litigation, tax, or other risks in general, without providing any information about the specific kinds of loss contingencies being evaluated are not sufficient.

Furthermore, I should point out that Statement 5 and Interpretation 14 [codified as ASC 450-20] require accrual for probable losses of the most likely amount of the loss. While the low end of a range of possible losses is the right number if no amount within the range is more likely than any other, I find it somewhat surprising how often “zero” is the recorded loss right up until a large settlement is announced. [Footnote omitted]

The SEC staff made similar remarks at subsequent conferences, including the 2010 AICPA National Conference on Current SEC and PCAOB Developments. To ensure compliance with the requirements in ASC 450-20, registrants should continually review their disclosures and update them as additional information becomes available.
Non-SEC registrants may also consider the preceding SEC staff remarks given that the disclosure objectives outlined by the staff would generally be expected to apply to the financial statements of non-SEC registrants as well.

2.8.2 Disclosure of Unasserted Claims

ASC 450-20-50-6 indicates that a disclosure of a loss contingency involving an unasserted claim is not required unless both of the following conditions are met:

a. “It is considered probable that a claim will be asserted.”

b. “There is a reasonable possibility that the outcome will be unfavorable.”

However, we believe that this exception is specific to unasserted claims and therefore should not be used by analogy beyond unasserted claims. An entity must evaluate all the facts and circumstances in determining whether to disclose such a loss contingency.

2.8.3 Disclosure of Loss Contingencies Occurring After Year-End

ASC 855-10-50-2 requires an entity to disclose a nonrecognized subsequent event if it is “of such a nature that [it] must be disclosed to keep the financial statements from being misleading.” Although this is a matter of judgment, it would seem prudent for an entity to disclose any matter that could materially affect its financial position, results of operations, or trend of operations. In addition, an entity should consider disclosing any accruals made in the subsequent reporting period as a nonrecognized subsequent event within the current-period financial statements if the accruals (1) are unusual or material to earnings of the current reporting period or (2) materially affect the trend of earnings.

Disclosures about a loss or loss contingency occurring after year-end should include (1) the nature of the loss or loss contingency and (2) an estimate of the amount or range of loss or possible loss or a statement that such an estimate cannot be made. If the effect on the entity’s financial position is material, it may be useful for the entity to provide supplemental pro forma financial data reflecting the loss as if it had occurred as of the date of the financial statements.

2.8.4 Disclosure of Firmly Committed Executory Contracts

<table>
<thead>
<tr>
<th>ASC 440-10</th>
</tr>
</thead>
</table>
| **50-2** An unconditional purchase obligation that has all of the following characteristics shall be disclosed in accordance with paragraph 440-10-50-4 (if not recorded on the purchaser’s balance sheet) or in accordance with paragraph 440-10-50-6 (if recorded on the purchaser’s balance sheet):

a. It is noncancelable, or cancelable only in any of the following circumstances:
   1. Upon the occurrence of some remote contingency
   2. With the permission of the other party
   3. If a replacement agreement is signed between the same parties
   4. Upon payment of a penalty in an amount such that continuation of the agreement appears reasonably assured.

b. It was negotiated as part of arranging financing for the facilities that will provide the contracted goods or services or for costs related to those goods or services (for example, carrying costs for contracted goods). A purchaser is not required to investigate whether a supplier used an unconditional purchase obligation to help secure financing, if the purchaser would otherwise be unaware of that fact.

c. It has a remaining term in excess of one year |
Unrecognized Commitments

50-4 A purchaser shall disclose unconditional purchase obligations that meet the criteria of paragraph 440-10-50-2 and that have not been recognized on its balance sheet. Disclosures of similar or related unconditional purchase obligations may be combined. The disclosures shall include all of the following:

a. The nature and term of the obligation(s)
b. The amount of the fixed and determinable portion of the obligation(s) as of the date of the latest balance sheet presented, in the aggregate and, if determinable, for each of the five succeeding fiscal years
c. The nature of any variable components of the obligation(s)
d. The amounts purchased under the obligation(s) (for example, the take-or-pay or throughput contract) for each period for which an income statement is presented.

The preceding disclosures may be omitted only if the aggregate commitment for all such obligations not disclosed is immaterial.

50-5 Disclosure of the amount of imputed interest necessary to reduce the unconditional purchase obligation(s) to present value is encouraged but not required. The discount rate shall be the effective initial interest rate of the borrowings that financed the facility (or facilities) that will provide the contracted goods or services, if known by the purchaser. If not, the discount rate shall be the purchaser’s incremental borrowing rate at the date the obligation is entered into.

Recognized Commitments

50-6 A purchaser shall disclose for each of the five years following the date of the latest balance sheet presented the aggregate amount of payments for unconditional purchase obligations that meet the criteria of paragraph 440-10-50-2 and that have been recognized on the purchaser’s balance sheet.

It may be appropriate for an entity to provide incremental disclosures pertaining to unconditional purchase obligations or firmly committed executory contracts if the criteria in ASC 440-10-50-2 are met. Specifically, when an executory contract is material and has not been recognized in the financial statements, the entity should consider the disclosure requirements of ASC 440-10-50-4(a) through 50-4(d). When the entity has recognized an executory contract on the balance sheet, it should disclose total payments for each of the five years following the date of the latest balance sheet.

SEC Considerations

In addition to the footnote disclosure requirements in ASC 440-10-50, incremental disclosures are required within the MD&A by SEC Regulation S-K, Item 303(a)(3)(ii) and Item 303(a)(5)(i):

(3) Results of operations. . . . (ii) Describe any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations. If the registrant knows of events that will cause a material change in the relationship between costs and revenues (such as known future increases in costs of labor or materials or price increases or inventory adjustments), the change in the relationship shall be disclosed.

(5) Tabular disclosure of contractual obligations. (i) In a tabular format, provide the information specified in this paragraph (a)(5) as of the latest fiscal year end balance sheet date with respect to the registrant’s known contractual obligations specified in the table that follows this paragraph (a)(5)(i). The registrant shall provide amounts, aggregated by type of contractual obligation. The registrant may disaggregate the specified categories of contractual obligations using other categories suitable to its business, but the presentation must include all of the obligations of the registrant that fall within the specified categories. A presentation covering at least the periods specified shall be included. The tabular presentation may be accompanied by footnotes to describe provisions that create, increase or accelerate obligations, or other pertinent data to the extent necessary for an understanding of the timing and amount of the registrant’s specified contractual obligations.
2.9 Subsequent-Event Considerations

Entities should have processes in place to capture and evaluate events that occur after the balance sheet date but before the financial statements are issued or are available to be issued to determine whether the events should be recognized in the current-period financial statements or in the subsequent-period financial statements.

The recognition, measurement, and disclosure principles related to loss contingencies described in this chapter apply to the period after the balance sheet date but before the financial statements are issued or are available to be issued.

ASC 450-20 includes guidance related to the accounting for subsequent events. ASC 450-20-25-2(a) indicates that an entity should consider “[i]nformation available before the financial statements are issued or are available to be issued” when determining whether it is probable that an asset had been impaired or that a liability had been incurred.

ASC 450-20

<table>
<thead>
<tr>
<th>25-2 An estimated loss from a loss contingency shall be accrued by a charge to income if both of the following conditions are met:</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Information available before the financial statements are issued or are available to be issued (as discussed in Section 855-10-25) indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. Date of the financial statements means the end of the most recent accounting period for which financial statements are being presented. It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.</td>
</tr>
<tr>
<td>b. The amount of loss can be reasonably estimated.</td>
</tr>
</tbody>
</table>

The purpose of those conditions is to require accrual of losses when they are reasonably estimable and relate to the current or a prior period. Paragraphs 450-20-55-1 through 55-17 and Examples 1–2 (see paragraphs 450-20-55-18 through 55-35) illustrate the application of the conditions. As discussed in paragraph 450-20-50-5, disclosure is preferable to accrual when a reasonable estimate of loss cannot be made. Further, even losses that are reasonably estimable shall not be accrued if it is not probable that an asset has been impaired or a liability has been incurred at the date of an entity’s financial statements because those losses relate to a future period rather than the current or a prior period. Attribution of a loss to events or activities of the current or prior periods is an element of asset impairment or liability incurrence.

| 25-6 After the date of an entity’s financial statements but before those financial statements are issued or are available to be issued (as discussed in Section 855-10-25), information may become available indicating that an asset was impaired or a liability was incurred after the date of the financial statements or that there is at least a reasonable possibility that an asset was impaired or a liability was incurred after that date. The information may relate to a loss contingency that existed at the date of the financial statements, for example, an asset that was not insured at the date of the financial statements. On the other hand, the information may relate to a loss contingency that did not exist at the date of the financial statements, for example, threat of expropriation of assets after the date of the financial statements or the filing for bankruptcy by an entity whose debt was guaranteed after the date of the financial statements. In none of the cases cited in this paragraph was an asset impaired or a liability incurred at the date of the financial statements, and the condition for accrual in paragraph 450-20-25-2(a) is, therefore, not met. |
The guidance in ASC 450 indicates that entities should consider events that occur before the financial statements are issued or are available to be issued when determining whether it is probable that a loss event occurred before the balance sheet date. ASC 450 does not specifically address events occurring after the balance sheet date that provide additional information related to the measurement of a loss contingency; however, entities should consider the subsequent-event guidance that is codified in ASC 855-10.

### ASC 855-10

**Recognized Subsequent Events**

*Evidence About Conditions That Existed at the Date of the Balance Sheet*

**25-1** An entity shall recognize in the financial statements the effects of all subsequent events that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements. See paragraph 855-10-55-1 for examples of recognized subsequent events.

**55-1** The following are examples of recognized subsequent events addressed in paragraph 855-10-25-1:

- **a.** If the events that gave rise to litigation had taken place before the balance sheet date and that litigation is settled after the balance sheet date but before the financial statements are issued or are available to be issued, for an amount different from the liability recorded in the accounts, then the settlement amount should be considered in estimating the amount of liability recognized in the financial statements at the balance sheet date.

- **b.** Subsequent events affecting the realization of assets, such as receivables and inventories or the settlement of estimated liabilities, should be recognized in the financial statements when those events represent the culmination of conditions that existed over a relatively long period of time. For example, a loss on an uncollectible trade account receivable as a result of a customer’s deteriorating financial condition leading to bankruptcy after the balance sheet date but before the financial statements are issued or are available to be issued ordinarily will be indicative of conditions existing at the balance sheet date. Thus, the effects of the customer’s bankruptcy filing shall be considered in determining the amount of uncollectible trade accounts receivable recognized in the financial statements at balance sheet date.

### Pending Content (Transition Guidance: ASC 326-10-65-1)

**55-1** The following are examples of recognized subsequent events addressed in paragraph 855-10-25-1:

- **a.** If the events that gave rise to litigation had taken place before the balance sheet date and that litigation is settled after the balance sheet date but before the financial statements are issued or are available to be issued, for an amount different from the liability recorded in the accounts, then the settlement amount should be considered in estimating the amount of liability recognized in the financial statements at the balance sheet date.

- **b.** Subsequent events affecting the realization of assets, such as inventories, or the settlement of estimated liabilities, should be recognized in the financial statements when those events represent the culmination of conditions that existed over a relatively long period of time.

### Nonrecognized Subsequent Events

*Evidence About Conditions That Did Not Exist at the Date of the Balance Sheet*

**25-3** An entity shall not recognize subsequent events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after the balance sheet date but before financial statements are issued or are available to be issued. See paragraph 855-10-55-2 for examples of nonrecognized subsequent events.
ASC 855-10 (continued)

55-2 The following are examples of nonrecognized subsequent events addressed in paragraph 855-10-25-3: . . .
   c. Settlement of litigation when the event giving rise to the claim took place after the balance sheet date but before financial statements are issued or are available to be issued
   d. Loss of plant or inventories as a result of fire or natural disaster that occurred after the balance sheet date but before financial statements are issued or are available to be issued . . .
   g. Entering into significant commitments or contingent liabilities, for example, by issuing significant guarantees after the balance sheet date but before financial statements are issued or are available to be issued.

50-2 Some nonrecognized subsequent events may be of such a nature that they must be disclosed to keep the financial statements from being misleading. For such events, an entity shall disclose the following:
   a. The nature of the event
   b. An estimate of its financial effect, or a statement that such an estimate cannot be made.

Connecting the Dots
ASC 450 and ASC 855 provide guidance on how to evaluate events occurring after the balance sheet date. The period through which subsequent events must be evaluated differs for (1) SEC filers and “conduit bond obligor[s] for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets)” and (2) entities that are neither SEC filers nor conduit bond obligors. SEC filers and conduit bond obligors should evaluate events that occur through the date on which the financial statements are issued, whereas entities that are neither SEC filers nor conduit bond obligors should evaluate events that occur through the date on which the financial statements are available to be issued. To determine whether an entity is a conduit bond obligor, entities should refer to the definitions of “SEC filer” and “conduit debt securities” in the ASC master glossary.

If an event takes place after the balance sheet date but before the financial statements are issued or are available to be issued, and the event indicates that it is probable that an asset has been impaired or a liability has been incurred as of the balance sheet date, the event is considered a recognized subsequent event. The event provides additional evidence of the loss incurred before the balance sheet date and should be reflected in the financial statements.

Examples of events that provide additional information about conditions that existed as of the balance sheet date and therefore should be accounted for as recognized subsequent events include the following:

• An unfavorable court ruling in a lawsuit. The company had previously determined that the likelihood of an unfavorable outcome would be remote or reasonably possible but now considers it probable.

• A litigation settlement that indicates a loss amount different from that previously recognized in the financial statements.

• The identification of asset misappropriation that occurred on or before the balance sheet date for which no loss had previously been recognized.
If events provide additional information that an asset had been impaired or a liability had been incurred as of the balance sheet date, but the amount of the loss cannot be reasonably estimated before the financial statements are issued or are available to be issued, the entity should consider whether disclosures are made in accordance with Section 2.8.1.

A loss should be recognized only when events confirm that an asset had been impaired or a liability existed as of the balance sheet date. If a loss contingency that did not exist as of the balance sheet date occurs after the balance sheet date but before the financial statements are issued or are available to be issued, the entity would not recognize the loss as of the balance sheet date but may need to disclose it as a subsequent event to keep the financial statements from being misleading.

The enactment of a law that gives rise to a liability after the balance sheet date but before the financial statements are issued or are available to be issued is a nonrecognized subsequent event. The newly enacted law does not provide evidence of conditions that existed as of the balance sheet date. However, the entity should consider whether it is required to disclose the event to keep the financial statements from being misleading. For additional information on the enactment of a law or legislation, see Section 2.3.1.3.

**Example 2-19**

**Legislation Enacted After the Balance Sheet Date**

Company A, a public entity with a December 31, 20X1, year-end, operates in the banking industry and is subject to proposed legislation that will impose a fee on deposits that existed as of June 30, 20X1. The legislation is expected to be enacted after year-end but before the issuance of the financial statements. Company A believes that because enactment of the legislation is probable and is related to balances as of a date before the balance sheet date, an accrual should be made. However, the obligating event in this case is the enactment of the legislation, before which A did not incur a liability even though a fee was assessed on preexisting balances; thus, no accrual should be made as of December 31, 20X1. Instead, the impact of the new legislation is a nonrecognized subsequent event, and A should consider whether it is required to disclose the event in its December 31, 20X1, financial statements to keep them from being misleading.

If a recognized contingent liability is settled after the balance sheet date but before the financial statements are issued or are available to be issued, a contingent liability should be reversed as of the balance sheet date to the extent that the recognized liability exceeds the settlement amount. The settlement constitutes additional evidence of conditions that existed as of the balance sheet date and would be considered a recognized subsequent event.
Chapter 3 — Gain Contingencies

3.1 Overview

ASC 450-30-20 defines a gain contingency as an “existing condition, situation, or set of circumstances involving uncertainty as to possible gain to an entity that will ultimately be resolved when one or more future events occur or fail to occur.” This chapter provides an overview of the accounting and disclosure requirements for gain contingencies, along with certain interpretive guidance on how to apply the gain contingency model. Chapter 4 provides an overview of the accounting model for gain contingencies that arise when recovery proceeds expected to be received are in excess of the related loss previously recognized in the financial statements.

The standard for recognition of gain contingencies is substantially higher than that for recognition of loss contingencies. ASC 450-30 indicates that a gain contingency should usually not be recognized before realization.

<table>
<thead>
<tr>
<th>ASC 450-30</th>
</tr>
</thead>
<tbody>
<tr>
<td>25-1 A contingency that might result in a gain usually should not be reflected in the financial statements because to do so might be to recognize revenue before its realization.</td>
</tr>
</tbody>
</table>

A gain contingency should not be recognized even if realization is considered probable. The notion of “probable” is relevant in accounting for a loss contingency, but it is not relevant in accounting for a gain contingency.
### 3.2 Gain Contingency Scope

All gain contingencies should be evaluated under ASC 450-30-25-1 unless another source of authoritative literature specifically prescribes a different accounting model. The table below provides a nonexhaustive list of examples of uncertainties related to the timing or amounts of future cash flows to be received that are within the scope of other literature.

<table>
<thead>
<tr>
<th>Reference</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>ASC 606-10</td>
<td>Seller’s estimation and constraint of estimates of the transaction price related to variable consideration (including a sale with a right of return) promised in a contract with a customer. (ASC 450-10-60-3)</td>
</tr>
<tr>
<td>ASC 610-20</td>
<td>Seller’s estimation and constraint of estimates of the transaction price in a contract for the sale of a nonfinancial asset or in-substance nonfinancial asset in a contract with a party other than a customer. (ASC 450-10-60-3)</td>
</tr>
<tr>
<td>ASC 720-20</td>
<td>“[R]ecognition of insurance recoveries by an entity insured through a purchased retroactive insurance contract,” other than for core insurance operations of an insurance entity. (ASC 450-30-60-4)</td>
</tr>
<tr>
<td>ASC 805-20</td>
<td>Indemnification assets acquired as part of a business combination. If an acquirer cannot determine the acquisition-date fair value of a contingency during the measurement period, it recognizes the contingency at its estimated amount if (1) “it is probable that an asset existed or that a liability had been incurred at the acquisition date” and (2) “[t]he amount of the asset or liability can be reasonably estimated.” These requirements are similar to those in ASC 450 related to loss contingencies.</td>
</tr>
<tr>
<td>ASC 805-30</td>
<td>Contingent consideration related to the receipt of previously transferred consideration for the purchase of a business.</td>
</tr>
<tr>
<td>ASC 815-10</td>
<td>Contingent consideration arrangements accounted for as a derivative.</td>
</tr>
<tr>
<td>ASC 840-10</td>
<td>Lessor accounting for contingent rental income. (ASC 450-30-60-5)</td>
</tr>
<tr>
<td>ASC 842-30</td>
<td>Lessor accounting for variable lease payments for sales-type leases, direct financing leases, or operating leases. (ASC 450-30-60-5)</td>
</tr>
<tr>
<td>Section F.3.4 of Deloitte’s A Roadmap to Consolidation: Identifying a Controlling Financial Interest</td>
<td>Contingent consideration accounting by the seller upon a subsidiary’s deconsolidation or derecognition of a group of assets that is a business.</td>
</tr>
</tbody>
</table>
3.3 Application of the Gain Contingency Model

ASC 450-30-25-1 refers to the recognition of revenue “before its realization.” We believe that the realization of a gain occurs at the earlier of when the gain is realized or is realizable.

Our view is based on paragraph 83 of FASB Concepts Statement 5 (codified in ASC 450), which states, in part:

Revenues and gains of an enterprise during a period are generally measured by the exchange values of the assets (goods or services) or liabilities involved, and recognition involves consideration of two factors, (a) being realized or realizable and (b) being earned, with sometimes one and sometimes the other being the more important consideration.

a. Realized or realizable. Revenues and gains generally are not recognized until realized or realizable. Revenues and gains are realized when products (goods or services), merchandise, or other assets are exchanged for cash or claims to cash. Revenues and gains are realizable when related assets received or held are readily convertible to known amounts of cash or claims to cash. Readily convertible assets have (i) interchangeable (fungible) units and (ii) quoted prices available in an active market that can rapidly absorb the quantity held by the entity without significantly affecting the price. [Footnote omitted]

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

- The gain has been realized
- The gain is realizable

Significant judgment is often required to determine when realization of a gain has occurred. Substantially all uncertainties about the realization of a gain contingency should be resolved before the gain contingency is considered realized or realizable and recognized in the financial statements. A gain is realized when cash or a claim to cash has been received and the cash (or claim to cash) is not subject to refund or clawback. A claim to cash supporting realization of a gain will often be in the form of a receivable. Such receivables may arise through (1) legally binding contractual arrangements detailing payment terms or (2) evidence provided by an insurer that all contingencies have been resolved and that the insurer will pay the insured party’s claim with no right to repayment. It may be appropriate to recognize a gain contingency when it is realizable, although we would generally not expect this to be a common occurrence. A gain is realizable when assets received or held are readily convertible to a known amount of cash (or claim to cash).

The conclusion that (1) a gain has been realized or (2) assets are readily convertible to cash in a known amount and therefore the gain is realizable must be supported by a thorough analysis of all relevant facts and circumstances related to the gain contingency. For an entity to recognize a gain contingency, the claim to cash must meet the definition of an asset in paragraph 25 of FASB Concepts Statement 6, which states that “[a]ssets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.” [Footnote omitted]

Connecting the Dots

Often, upon a litigation settlement determined by the courts or other authoritative bodies, an agreement is executed that outlines the payments to be made by one or both of the parties and the timing thereof. In these situations, there is no longer a gain contingency because the agreement represents a claim to cash, and therefore the gain has been realized. The executed agreement represents a contractual receivable since there are no contingencies remaining. The party expecting to receive cash proceeds would assess the contractual receivable for impairment as described in Section 2.2.3.
In reaching a conclusion that a gain has been realized or is realizable, an entity should consider the nonexhaustive list of factors in the illustration below. Sections 3.4 through 3.6 expand upon the factors shown in the illustration.

In addition to the factors identified above, the entity should also consider additional facts and circumstances, the nature of the agreement, and consulting with accounting advisers as further discussed below.

<table>
<thead>
<tr>
<th>Additional Facts and Circumstances</th>
<th>An entity meeting all the aforementioned criteria should consider its individual facts and circumstances to determine whether any additional factors lead it to conclude that realization or realizability has not yet occurred.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nature of the Agreement</td>
<td>An oral agreement may be legally binding in certain situations. For example, to recognize revenue within the scope of ASC 606, an entity must have a contract with a customer that is agreed to “in writing, orally, or in accordance with other customary business practices.” This requirement is based on the FASB’s conclusion that a revenue contract must be enforceable by law for an entity to recognize the rights and obligations arising from the contract. Gain contingencies, by their nature, are generally expected to occur less frequently than revenue transactions. Accordingly, it is considerably less likely that oral evidence or sufficient history establishing a customary business practice would have occurred that would constitute a legally binding contract. Therefore, we would generally expect that a written agreement would need to be in place for a gain contingency to be recognized.</td>
</tr>
<tr>
<td>Consultation With Accounting Advisers</td>
<td>Given the high recognition threshold that needs to be reached before a gain contingency should be recognized, entities may determine that consultation with their accounting advisers is warranted when evaluating exactly when realization or realizability of a gain contingency has occurred. For example, while the realization principle described above does not mandate that cash be received before realization can be deemed to have occurred, in many situations, the timing of receipt of cash may coincide with the timing of when all remaining uncertainties surrounding the gain contingency have been resolved.</td>
</tr>
</tbody>
</table>
3.4 Legal Disputes and Legislative or Regulatory Approval

Because of the number of uncertainties inherent in a litigation proceeding, gain contingencies resulting from favorable legal settlements generally cannot be recognized in income until cash or other forms of payment are received. Gain recognition typically is not appropriate when a favorable legal settlement remains subject to appeal or other potential reversals. Often, gain contingency recognition will be deferred even after a court rules in favor of a plaintiff.

Example 3-1

Legal Dispute — Declaration of Award

Company W, which produces and sells construction materials, has a dispute with Company O, a contractor it engaged to perform construction services. Company O ceases the work before its completion, and W subsequently declares the contract canceled because of various issues concerning O’s performance of its obligations under the contract. Company W files a claim against O, and the parties enter into arbitration. The arbitrator declares that O is to pay W $4 million. The arbitrator’s judgment may be appealed to a higher court. Because there is no direct linkage between the arbitration award granted and the costs W previously incurred under the contract with O, the arbitration award is a gain contingency rather than the recovery of a previously incurred loss, and W should not recognize the $4 million award before its realization or when it’s considered realizable.

Connecting the Dots

In the example above, Company W should not recognize the $4 million gain contingency award because all possible appeals have not yet been exhausted, and accordingly, W’s gain contingency is not considered realized or realizable. This threshold for recognizing a gain contingency is higher than the “probable and reasonably estimable” threshold required for recognition of a loss contingency (see Chapter 2) or a loss recovery (see Chapter 4).

Separately, Company O would recognize a loss contingency after the arbitrator’s judgment because the criteria under ASC 450-20 have been met. The arbitrator’s ruling is significant objective evidence of the probability that O has incurred a liability, and O concludes that it does not have sufficient evidence to counterbalance this adverse ruling. Further, the $4 million that O will pay to W for settlement of the dispute is reasonably estimable on the basis of the arbitrator’s ruling. Because of the different thresholds for recognition of gain contingencies versus those for recognition of loss contingencies or loss recoveries, it is not uncommon for one party in a dispute to recognize a loss contingency while the counterparty does not recognize the gain contingency.

Although an entity may be certain that it will receive proceeds from a legal settlement because there is no possibility of additional appeals, other uncertainties may remain that indicate that the gain has not yet been realized. Examples 3-2 and 3-3 below illustrate contrasting scenarios in which the ultimate amount to be received is not estimable in one case and is known in the other.

Example 3-2

Legal Dispute — Cash Is Received in Escrow: Amount Not Estimable

Company R is a plaintiff in a class action lawsuit against several drug manufacturers. After a lengthy appeals process, a final settlement is reached. The drug manufacturers place the funds in an escrow account because there is no agreement on how to allocate the settlement among the attorneys and each respective plaintiff. Because R does not know the amount of cash to be received, gain recognition is inappropriate.
Example 3-3

Legal Dispute — Cash Is Received in Escrow: Amount Known

Assume the same facts as in Example 3-2, except that the amount to be paid to Company R and to all other plaintiffs is known. In addition, the cash has already been placed in escrow and will be paid by the court-appointed escrow holder after it performs various administrative tasks (i.e., preparing and processing the wire payments to plaintiffs). None of the other plaintiffs are contesting the outcome or allocation of the settlement. The cash is nonrefundable to the drug manufacturers, and there is no potential for appeal or reversal. Company R has not identified any additional facts or circumstances related to this gain contingency that call into question whether the gain has been realized. After consulting with its accounting advisers, R concludes that gain recognition is appropriate with the provision of sufficient disclosure about the status of realization. Company R's realized claim to payment as detailed in the agreement would represent a contractual receivable subject to an impairment assessment.

If a legal settlement is reached but is pending regulatory or legislative approval, gain recognition is not appropriate until all required levels of regulatory and legislative approval have been obtained. This is the case even if the entity can demonstrate that the settlement meets all criteria that are evaluated by a regulatory body when it is determining whether to grant approval.

Example 3-4

Legal Dispute — Perfunctory Regulatory Approval

Company Q, a builder of homes and condominiums, estimates that it has been overcharged by the city for sewer tap fees over a period of several years. Subsequently, Q and the city negotiate a settlement on the basis of the estimated overcharges that requires the city to refund $1 million in cash and provide Q with $1 million in credits toward future sewer tap fees. Because the overcharges are estimates and there is no direct linkage to previous costs incurred, the entire settlement amount is a gain contingency. The settlement is negotiated and signed by a representative of the city but is contingent on approval by the city council. Company Q believes that such approval is perfunctory and has obtained a legal opinion that the sewer credits can be used immediately upon the signing of the agreement. Since the agreement is expressly conditioned on approval by the city council, all levels of governmental approval have not yet been obtained. Therefore, recognition of the gain should be deferred.

Example 3-5

Legal Dispute — Expectation of Regulatory Approval

Company A sells power to Municipal Agency M under a long-term supply contract. Because power prices have fallen substantially below those M has agreed to pay, M has notified A that it plans to terminate the supply contract. Under the contract's terms, termination will result in a payment of $100 million from M to A. After considering expenses associated with terminating the agreement, A believes that it will recognize a $50 million gain upon termination.

Municipal Agency M cannot terminate the agreement until it obtains written approval from the state's energy regulatory agency, which is not expected until after year-end. Company A knows the criteria that the state's energy regulatory agency will use to evaluate the agreement termination and has no doubt that A has met the criteria. An expectation of approval by the regulatory agency, even with the understanding of the regulatory agency's approval criteria, would not be sufficient for A to recognize the gain. The gain is subject to regulatory approval and should not be recognized until it has been obtained.
3.5 Settling Litigation by Entering Into an Ongoing Business Relationship
An entity may recognize gains related to the settlement of litigation achieved by entering into an ongoing business relationship when the revenue recognition criteria for such a relationship have been met. Such a situation may exist when a litigation settlement agreement includes past obligations and disputes and modifies the ongoing contractual terms of the business relationship. When the contractual relationship is with a customer, the entity should apply ASC 606; otherwise, the entity may find it appropriate to apply ASC 610-20. In accounting for a litigation settlement that also includes a revenue element, an entity should consider bifurcating the settlement into its different elements, as described in an SEC staff speech at the 2007 AICPA National Conference on Current SEC and PCAOB Developments (see Section 2.2.5 for further discussion).

In addition, regarding classification of the settlement, entities should consider the guidance in ASC 606 when making payments to a customer and in ASC 705-20 when receiving payments from a vendor. See Section 2.2.6.1 for further discussion.

3.6 Gain Realization Contingent on Future Performance Requirements
An entity’s realization of a gain may be contingent on whether the entity meets a future performance requirement. Alternatively, realization of a gain may be contingent on future events outside the entity’s control. In both cases, uncertainty remains, and recognition of the gain contingency is not appropriate.

Connecting the Dots
Other areas of U.S. GAAP (e.g., ASC 718) prescribe different accounting treatment when uncertainty or contingent events are outside or within the entity’s control. As long as the uncertainty is within the scope of the gain contingency guidance in ASC 450-30, the entity should not analogize to other areas of guidance in U.S. GAAP when evaluating the appropriateness of recognition of a gain contingency.

Example 3-6
Probable Occurrence of a Contingent Future Event
Company J contracts to outsource its data processing function to Company K for a period of seven years. Approximately four years into the agreement term, K seeks to terminate the agreement. Companies J and K sign a termination agreement that provides for the following:

- The agreement will fully terminate and K will cease processing transactions six months after the signing of the termination agreement.
- Company J is required to find alternative outsourcing services before the end of the six-month term.
- Company K must pay J $5 million for signing the termination agreement. The payment from K to J is made upon the signing of the termination agreement but is subject to clawback if J fails to find alternative outsourcing services.
- If J fails to obtain the alternative outsourcing, K is required to provide such a service but may charge 150 percent of the standard monthly fee for such a service.

Company J believes that it is probable that the conversion to a new provider will be accomplished within the required time frame. Accordingly, J would like to recognize the $5 million termination fee in income. However, the recognition of the termination fee in income is contingent on J’s ability to obtain alternative outsourcing by the specified date. Therefore, the recognition of the termination fee should be deferred until J has resolved all uncertainties related to the termination agreement. This will be achieved through successful negotiation of another outsourcing agreement for J’s data processing function.
Example 3-7

**Contingent Future Event Requiring No Additional Performance**

Assume the same facts as in Example 3-6, except that Company J is capable of processing its transactions in-house after Company K ceases transaction processing, and J intends to do so. The agreement does not terminate until six months after the signing of the termination agreement. Even though J does not have to provide any future performance given that it already has the proven capability and intent to process its own transactions, gain recognition is not appropriate because the agreement does not terminate until six months after the signing of the termination agreement. The clawback provision related to the $5 million payment does not expire until the end of the six-month term, at which time gain recognition would be appropriate.

3.7 Gain Contingency Disclosure

<table>
<thead>
<tr>
<th>ASC 450-30</th>
</tr>
</thead>
<tbody>
<tr>
<td>50-1 Adequate disclosure shall be made of a contingency that might result in a gain, but care shall be exercised to avoid misleading implications as to the likelihood of realization.</td>
</tr>
</tbody>
</table>

Even if insurance proceeds resulting in a gain or other gain contingencies are not recognized in the financial statements because of unresolved uncertainties, timely disclosure of the insurance gain contingency should be considered. Disclosures might include (1) the nature of the gain contingency, including description of any remaining uncertainties; (2) the parties involved; (3) the timeline of previous events; (4) an expected timeline for resolving the remaining uncertainties; and (5) the amount of the gain contingency, including consideration of uncertainties in the determination of the amount. If the entity is unable to determine the timeline for resolution or an estimate of the amount to ultimately be realized, the factors the entity considered in making these conclusions may need to be disclosed and updated in future financial statements as additional information becomes available.

The entity should take care to avoid making misleading disclosures about the likelihood, timing, or amount of the potential gain contingency. Disclosures should also include the entity's accounting policy for the recognition of recovery proceeds of previously recognized losses as well as proceeds expected to be received in excess of previously recognized losses (see further discussion in Chapter 4).

For gain contingency classification considerations, see Section 4.8.

3.8 Subsequent-Event Considerations

Entities should evaluate events that occur after the balance sheet date but before the financial statements are issued or are available to be issued to determine whether the events should be recognized in the current-period financial statements or in the subsequent-period financial statements.

The recognition, measurement, and disclosure principles related to gain contingencies that are described in this chapter apply to the period after the balance sheet date but before the financial statements are issued or are available to be issued.

The resolution of a gain contingency that results in a gain after the balance sheet date but before the financial statements are issued or are available to be issued generally should not be considered a recognized subsequent event. ASC 855-10-15-5(c) indicates that gain contingencies “are rarely recognized after the balance sheet date but before the financial statements are issued or are available to be issued” and provides a cross-reference to ASC 450-30-25-1, which states that “[a] contingency that might result in a gain usually should not be reflected in the financial statements because to do so might be to recognize revenue before its realization.”
Chapter 4 — Loss Recoveries

4.1 Overview

Previous chapters of this Roadmap address the accounting for loss and gain contingencies. This chapter addresses the accounting for recoveries pertaining to a previously recognized financial statement loss (e.g., an impairment of an asset or incurrence of a liability), as well as recoveries from business interruption insurance. Insured losses might result from partial or full destruction of an entity’s property or equipment because of fire, earthquake, hurricane, or other natural disasters, as well as losses that arise from asbestos exposure or environmental matters. Insured losses can also come in the form of insured director and officer costs as well as from fraudulent activities undertaken by employees. Loss recoveries may be received from litigation settlements, insurance proceeds, or reimbursement of an employee’s fraudulent activities through liquidation of the employee’s assets.

Questions may arise about how and when to account for insurance proceeds or other recoveries received. This chapter addresses the four accounting models that an entity should consider when determining the recognition and measurement of expected proceeds related to a recovery: (1) loss recovery model, (2) gain contingency model, (3) determinable mix of loss recovery and gain contingency models, and (4) indeterminable mix of loss recovery and gain contingency models.

<table>
<thead>
<tr>
<th>Loss recovery model</th>
<th>An asset for which realization is probable should be recognized only up to the amount of the previously recognized loss. The analysis of whether recovery is probable is consistent with the guidance on loss contingency recognition in Chapter 2. See Section 4.3 for additional information.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gain contingency model</td>
<td>Recovery proceeds related to a loss that has not been recognized in the financial statements should be accounted for as a gain contingency as described in Chapter 3. See Section 4.3 for additional information.</td>
</tr>
<tr>
<td>Determinable mix of loss recovery and gain contingency models</td>
<td>A combination of the loss recovery and the gain contingency models is applied when recovery proceeds are expected to exceed the amount of the previously recognized loss. The probable recovery proceeds equal to the amount of the recognized loss should be accounted for by using the loss recovery model. The expected proceeds in excess of the recognized loss should be accounted for by using the gain contingency model. For an entity to apply the determinable mix model, there must be a direct linkage between the recovery proceeds and the specifically identifiable recognized loss. See Section 4.4 for additional information.</td>
</tr>
</tbody>
</table>
An indeterminable mix of the loss recovery and gain contingency models results from a situation in which there is either no clear evidence that the amount of the recovery proceeds is a recovery of previously recognized losses or costs (i.e., there is no direct linkage) or the amount of the loss or costs previously incurred is not objectively quantifiable (i.e., the losses or costs are not specific, incremental, identifiable costs or losses). Under these circumstances, the application of the gain contingency model would be appropriate for the entire amount of the recovery proceeds. See Section 4.4 for additional information.

These four models are based on the loss contingency model and the gain contingency model, both of which are codified in ASC 450. In addition, the accounting for recovery proceeds builds upon ASC 450, drawing from other parts of current and superseded U.S. GAAP, including guidance on involuntary conversions (ASC 610-30); how to account for the impact of the September 11, 2001, terrorist attacks (EITF Issue 01-10); and environmental obligations (ASC 410-30). This chapter describes how these additional sources of U.S. GAAP form the basis for the accounting for recovery proceeds.

4.2 Involuntary Conversions

Insurance is often maintained to mitigate losses in the event of property damage or casualty losses. The recognized loss and the associated recovery proceeds (through insurance proceeds or other source of recovery) are treated as two separate events and therefore two separate units of account. The principle underlying this separation, which is the basis for the accounting models described in Sections 4.3 and 4.4, is derived from the involuntary conversion guidance codified in ASC 610-30.

<table>
<thead>
<tr>
<th>ASC 610-30</th>
<th>Pending Content (Transition Guidance: ASC 606-10-65-1)</th>
</tr>
</thead>
<tbody>
<tr>
<td>25-2</td>
<td>An involuntary conversion of a nonmonetary asset to monetary assets and the subsequent reinvestment of the monetary assets is not equivalent to an exchange transaction between an entity and another entity. The conversion of a nonmonetary asset to monetary assets is a monetary transaction, whether the conversion is voluntary or involuntary, and such a conversion differs from exchange transactions that involve only nonmonetary assets. To the extent the cost of a nonmonetary asset differs from the amount of monetary assets received, the transaction results in the realization of a gain or loss that shall be recognized.</td>
</tr>
<tr>
<td>25-3</td>
<td>Involuntary conversions of nonmonetary assets to monetary assets are monetary transactions for which gain or loss shall be recognized even though an entity reinvests or is obligated to reinvest the monetary assets in replacement nonmonetary assets. However, the requirement of this Subtopic with respect to gain recognition does not apply to an involuntary conversion of a last-in, first-out (LIFO) inventory for which replacement is intended but not made by year-end and the taxpayer does not recognize gain for income tax reporting purposes. Paragraph 270-10-45-6(b) provides an exception for the liquidation of a LIFO inventory at an interim date if replacement is expected by year-end. Accordingly, that exception applies to an involuntary conversion of a LIFO inventory if replacement is expected by year-end.</td>
</tr>
<tr>
<td>25-4</td>
<td>In some cases, a nonmonetary asset may be destroyed or damaged in one accounting period, and the amount of monetary assets to be received is not determinable until a subsequent accounting period. In those cases, gain or loss shall be recognized in accordance with Topic 450.</td>
</tr>
</tbody>
</table>
When a nonmonetary asset (e.g., property) is involuntarily converted to a monetary asset (e.g., an insurance receivable), an entity must recognize the effects of the monetary transaction even if the proceeds are reinvested (voluntarily or by requirement) in the replacement or repair of the nonmonetary asset. The loss of a nonmonetary asset and subsequent monetary recovery through insurance are therefore accounted for as two separate units of account.

**Example 4-1**

**Involuntary Conversion**

A fire destroys Company X’s operating plant. Company X must write off the plant, recognizing a loss, regardless of its decision or the insurance company’s requirements to use the proceeds to replace or repair the plant. Any insurance proceeds received are accounted for separate and apart from the incurred loss.

If the property or equipment is destroyed or damaged in one period and the recovery proceeds are not determinable until a subsequent period, X recognizes the loss when incurred, without consideration of the possible recognition of a monetary recovery (e.g., cash proceeds).

**4.3 Loss Recovery and Gain Contingency Models**

In determining whether an asset can be recognized for expected proceeds (e.g., proceeds from an insurance policy), an entity must first consider the amount of the expected proceeds in comparison to the related previously recognized loss, if any. This comparison is illustrated below in the context of the loss recovery and gain contingency models.

**Loss Recovery Model**

<table>
<thead>
<tr>
<th>Loss Recovery*</th>
<th>$10 probable insurance proceeds directly related to $10 recognized loss</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$10 recognized loss</td>
</tr>
</tbody>
</table>

* The ultimate net income statement effect of the recognized loss and the insurance proceeds directly related to the recognized loss to the income statement is zero; however, the period in which the loss and the insurance proceeds are recognized may differ.

**Gain Contingency Model**

<table>
<thead>
<tr>
<th>Gain Contingency</th>
<th>$10 probable insurance proceeds directly related to $0 recognized loss</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$0 recognized loss</td>
</tr>
</tbody>
</table>

Although not codified, paragraph 16 of EITF Issue 01-10 notes that a gain is “a recovery of a loss not yet recognized in the financial statements or an amount recovered in excess of a loss recognized in the financial statements.” Consequently, a loss recovery could be defined as the inverse: recovery proceeds up to the amount of the financial statement loss incurred. The recognition threshold for a loss recovery is that it is probable, as indicated by ASC 410-30-35-8, which states that “an asset relating to the recovery shall be recognized only when realization of the claim for recovery is deemed probable.”
An asset related to a recovery should be recognized for a previously recognized financial statement loss when the recovery is probable. The amount greater than the previously recognized loss or a recovery of a loss not yet recognized in the financial statements should be treated as a gain contingency.

ASC 410-30 addresses the accounting for recovery proceeds related to environmental remediation liabilities. Although that guidance is specific to environmental matters, an entity should apply the recognition and measurement principles in ASC 410-30-35-8 and 35-9 when determining the appropriate recognition of other loss recoveries unrelated to environmental matters.

**ASC 410-30**

35-8 . . . The amount of an environmental remediation liability should be determined independently from any potential claim for recovery, and an asset relating to the recovery shall be recognized only when realization of the claim for recovery is deemed probable. The term probable is used in this Subtopic with the specific technical meaning in paragraph 450-20-25-1.

35-9 If the claim is the subject of litigation, a rebuttable presumption exists that realization of the claim is not probable.

A company that incurs a loss attributable to impairment of an asset or incurrence of a liability and expects to recover all or a portion of that loss through an insurance claim should record an asset for the amount considered probable of recovery from the insurance claim (not to exceed the amount of the total losses recognized). Subsequent recognition of amounts greater than an amount initially deemed probable of recovery from an insurance claim should be only of those amounts considered probable of recovery to the extent that they do not exceed actual additional covered losses or direct, incremental costs incurred to obtain the insurance recovery. Any recovery expected that is greater than covered losses or direct, incremental costs incurred represents a gain contingency and therefore requires a higher recognition threshold as described throughout Chapter 3.

**Example 4-2**

**Determine Probability of a Noninsurance Recovery**

Company S discovers that its CFO has perpetrated a fraud by drawing down on a corporate line of credit of $20 million into her personal bank account. Company S's outside counsel meets with the bank to discuss the fraud and advises S that it will be obligated to repay to the bank the money withdrawn by the CFO. A forensic investigation of the CFO's personal accounts and holdings uncovers approximately $8 million in assets that could be liquidated (subject to court approval) and applied toward the $20 million obligation.

Company S recognizes a loss of $20 million upon discovery of the CFO's fraud and receipt of the bank's communication that S will be responsible for full payment of the $20 million. Although the $8 million is not an insurance policy, the considerations S needs to take into account to determine whether to recognize the $8 million of the CFO's assets as a recovery asset for the previously incurred $20 million loss are similar to the considerations S would need to take into account to determine whether to recognize insurance proceeds as a recovery asset.

Because S has recognized the full $20 million loss in its financial statements, it should apply the loss recovery model to the $8 million possible recovery and conclude whether recovery is probable. If S is able to conclude on the basis of consideration of all factors that recovery is probable, it may recognize an asset for this expected recovery. If S is unable to conclude that recovery is probable, it should not recognize an asset related to recovery unless and until such recovery becomes probable.
A conclusion that a potential insurance recovery is probable may involve significant judgment and should be based on all relevant facts and circumstances. Insurance proceeds that will result in a gain generally should be recognized at the earlier of when the proceeds are realized or realizable. Such insurance proceeds are realized when the insurance carrier settles the claim and no longer contests payment. Payment alone does not mean that realization has occurred if such payment is made under protest or is subject to refund. Recognition of the proceeds may be appropriate after consideration of the conditions outlined in Section 3.3. Further, an entity should analyze insurance proceeds accounted for as a loss recovery by applying the “probable” criterion used when determining a loss contingency (whether an asset has been impaired or a liability has been incurred), as outlined in Section 2.3.1.1.

SEC Considerations

The guidance in ASC 410-30-35-9 is consistent with the SEC staff's interpretive guidance in Question 2 of SAB Topic 5.Y (codified in ASC 450-20-S99-1). However, additional disclosure requirements are included in footnote 49 of that guidance, which addresses uncertainties regarding the legal sufficiency of insurance claims or solvency of insurance carriers:

The staff believes there is a rebuttable presumption that no asset should be recognized for a claim for recovery from a party that is asserting that it is not liable to indemnify the registrant. Registrants that overcome that presumption should disclose the amount of recorded recoveries that are being contested and discuss the reasons for concluding that the amounts are probable of recovery.

It is likely that in determining whether it is probable that an entity will receive an insurance recovery, the entity will need to understand, among other factors, the solvency of the insurance carrier and have sufficient dialogue and historical experience with the insurer related to the type of claim in question to assess likelihood of payment. Further, consultation with legal counsel may be necessary.

Example 4-3

**Insurance Recovery of Replacement Cost**

A fire destroys Company H's main operating plant. Immediately after the fire, H recognizes a loss for the net book value of the plant and meets with the insurance adjuster to evaluate the loss and expedite the claim. Given a similar fire loss three years earlier, both parties are familiar with H's plant and the process by which the adjuster will determine H's claim settlement amount.

Because H is constructing a similar plant, H and the adjuster are also familiar with the replacement cost of the plant. Accordingly, the adjuster is able to quickly estimate the minimum property damage claim and implement appropriate procedures to process the claim and establish a schedule of reimbursements. The adjuster computes and the insurance carrier approves (settles) a minimum reimbursement for the cost of replacement; the amount is greater than the net book value of the old plant. Company H appropriately recognizes a gain for the excess of the minimum reimbursement over the net book value of the property since the amount was considered realized when the insurance carrier settled the claim and no longer contested the payment to be made to H.

Connecting the Dots

Some incurred losses may relate to past events spanning multiple years or decades, such as losses that arise from asbestos exposure or environmental matters. In these situations, the losses may span periods covered by several insurance carriers, some of which may no longer be solvent, or various policies. Therefore, it may be challenging for an entity to determine whether the incurred loss is a covered event, whether because of vague language used in prior insurance policies or the number of policies or insurance carriers that may have existed at any given time. The entity should consider these potential limitations and factor them into its calculation of the probability that it will receive an insurance recovery for losses spanning multiple years.
4.4 Determinable and Indeterminable Mix of Loss Recovery and Gain Contingency Models

When there is no clear evidence that the amount of the recovery proceeds is a recovery of previously recognized losses or incremental costs (i.e., there is no direct linkage) or the amount of the loss or costs previously incurred is not objectively quantifiable (i.e., specifically identifiable), the application of the gain contingency model would be appropriate for the entire amount of the recovery proceeds. The determinable mix model, which encompasses both the loss recovery and gain contingency models, and the indeterminable mix model, which results in the application of the gain contingency model to probable recovery proceeds, are illustrated below.

The probable recovery proceeds equal to the amount of the recognized loss should be accounted for by using the loss recovery model. The expected proceeds in excess of the recognized loss should be accounted for by using the gain contingency model.

**Determinable Mix Model**

<table>
<thead>
<tr>
<th>Gain Contingency*</th>
<th>$10 probable insurance proceeds directly related to $5 recognized loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loss Recovery**</td>
<td>$5 recognized loss directly related to insurance proceeds</td>
</tr>
</tbody>
</table>

* Gain contingency model for $5 proceeds in excess of $5 recognized loss.
** Loss recovery model for $5 proceeds up to $5 recognized loss.

Application of the gain contingency model for the entire amount of the probable proceeds is illustrated below.

**Indeterminable Mix Model**

<table>
<thead>
<tr>
<th>Gain Contingency*</th>
<th>$10 probable insurance proceeds not directly related to $5 recognized loss</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$0</td>
</tr>
<tr>
<td></td>
<td>$5 recognized loss not directly related to insurance proceeds</td>
</tr>
</tbody>
</table>

* Gain contingency model for all probable proceeds.

Example 4-4 below illustrates the application of the indeterminable mix model, whereas Example 4-5 illustrates the application of the determinable mix model.
Example 4-4

**Indeterminable Mix of Loss Recovery and Gain Contingency Models**

Company T joins a class action lawsuit against Credit Card Company Y because Y has overcharged for various credit card transactions over the past 10 years. Credit Card Company Y and T enter into a settlement agreement, subject to the final approval of the claims administrator, for an estimated amount of $35 million payable to T over the next 5 years. Company T concludes that it is probable that it will receive at least $35 million from the settlement. The settlement agreement includes the recovery of actual and estimated overcharges, punitive damages, payment to avoid further cost of litigation, and payment to restore a collaborative business relationship.

The recovery of the overcharges amount is based on actual and estimated overcharges over the past 10 years. Company T is unable to determine a direct linkage between (1) what represents cost recovery of the previously recognized overcharges and (2) punitive damages. Further, Y contends in all legal proceedings that the lawsuit is without merit and that T has not previously incurred any losses. From Y's perspective, it is settling the lawsuit to restore a collaborative business relationship rather than to repay T's incurred losses. Accordingly, the amount of the loss previously incurred is not objectively quantifiable.

For T to characterize an amount as a loss recovery, the amount should represent the reimbursement of specific, incremental, identifiable costs previously incurred. Company T determines that it is unable to objectively determine how much of the settlement represents recovery of previously recognized overcharges. Therefore, T applies the gain contingency model to the entire amount of the settlement. Uncertainties remain regarding the settlement's approval, and therefore, T should defer recognition of the gain until sufficient information is available for T to conclude that the gain is realized or realizable.

4.5 **Insurance Deductible**

Before recognizing an asset for expected insurance proceeds, an entity should consider the individual policy covering the loss and analyze whether the asset should be reduced for any policy-related deductibles.

Example 4-5

**Insurance Recovery of Fair Market Value With Deductible**

An earthquake destroys Company R's corporate headquarters. At the time of the earthquake, the net book value of the corporate headquarters is $350,000. Company R's insurance policy covers fair market value of the property, and R has a $50,000 deductible. In accordance with the insurance policy, the fair market value of the corporate headquarters is based on a third-party appraisal before the earthquake. Company R carefully analyzes the provisions of the insurance policy regarding the deductible. Using an external expert, R determines that the fair value of the corporate headquarters before the earthquake was $500,000.

In the same period as the earthquake, the insurance adjuster communicates to R that once the fair value is determined, an amount equal to the fair market value of the property, reduced by the deductible, will be paid to R, and the amount will not be subject to refund. Because this is a determinable mix of a loss recovery and a gain contingency, in the current period in which the earthquake occurs, R recognizes a loss of $350,000 for the net book value of the destroyed corporate headquarters and a corresponding insurance recovery receivable of $350,000. The loss recovery receivable is recognized because R concludes that it is probable that the insurance recovery will be realized.

Because it is probable that the insurance recovery will be realized and the fair value of the facility was determined to be well above the net book value of the corporate headquarters, we believe that it would be appropriate for R to recognize the entire $350,000 loss recovery in the period in which the loss on the property is recognized. In a scenario in which there is sufficient evidence to support the insurance payment (in this case, $450,000, which represents the $500,000 fair market value of the property reduced by the $50,000 deductible) will exceed the amount of recognized loss (in this case, $350,000), it would be appropriate for R to recognize an insurance recovery receivable in an amount of $350,000 and apply the deductible to the deferred gain, which represents the excess amount of fair market value over the net book value of the property.
Example 4-5 (continued)

The deferred gain is the $100,000 difference between the expected insurance proceeds of $450,000 less the $350,000 recognized recovery receivable. Such a gain contingency should not be recognized until all contingencies are resolved and the insurance proceeds are realized. In this example, R may conclude that the $100,000 is realized once the adjuster pays or confirms the related covered amount (the fair value of the corporate headquarters) and the amount is no longer contested or subject to refund (see Chapter 3 for additional considerations on the determination of the appropriate period in which to recognize the gain contingency).

Evidence to Support Probable Receipt of $350,000 Insurance Proceeds

To recognize the $350,000 recovery receivable, R considered whether it had sufficient evidence to support recognition of the full amount of the loss recovery receivable. If, for example, the external expert had determined the fair value of the corporate headquarters to be $400,000 rather than $500,000, it may have been more difficult for R to conclude that the full $350,000 loss recovery asset would have been received because there would have been no excess (i.e., cushion) of fair value over the net book value of the property. In these situations, an entity could consider consulting with its accounting advisers.

4.6 Business Interruption Insurance

ASC 220-30-20 defines business interruption insurance as “[i]nsurance that provides coverage if business operations are suspended due to the loss of use of property and equipment resulting from a covered cause of loss. Business interruption insurance coverage generally provides for reimbursement of certain costs and losses incurred during the reasonable period required to rebuild, repair, or replace damaged property.” ASC 220-30-05-2 further notes the following regarding business interruption insurance:

The types of costs and losses covered by business interruption insurance typically include the following:

a. Gross margin that was lost or not earned due to the suspension of normal operations
b. A portion of fixed charges and expenses in relation to that lost gross margin
c. Other expenses incurred to reduce the loss from business interruption (for example, rent of temporary facilities and equipment, use of subcontractors, and so forth).

The guidance in Section 4.3 on loss recoveries and gain contingencies applies to the accounting for business interruption insurance. That is, certain fixed costs incurred during the interruption period may be analogous to losses from property damage, and accordingly, it may be appropriate to recognize a receivable (not to exceed the amount of costs incurred) for amounts considered probable of recovery. A recovery receivable should be recognized into income when the direct and incremental losses are incurred if the entity concludes that receipt of the recovery proceeds is probable. A recovery receivable should be recognized only up to the amount of the financial statement loss incurred (e.g., the fixed costs incurred). The possible recovery of lost profit margin should be considered a gain contingency since the absence of expected profit margin would not be considered a previously recognized financial statement loss. Therefore, the recovery of lost profit margin should be recognized into income when the gain contingency is resolved (i.e., the proceeds are realized or realizability). Because of the usually complex and uncertain nature of the settlement negotiations process, recognition of the lost profit margin (i.e., the gain contingency) may occur at the time of final settlement or when nonrefundable cash advances are made.
Because business interruption insurance may be paid in a lump-sum amount to the insured, including reimbursement for both property damage and lost profit margin, it may be difficult to determine whether the recovery is for losses previously recognized in the financial statements (i.e., whether the recovery should be considered a determinable mix or an indeterminable mix of loss recovery and gain contingency). We encourage entities to consult with their independent accountants in connection with their evaluation of whether a receivable may be recognized for expected insurance recoveries associated with fixed costs incurred during the interruption period.

**Connecting the Dots**

There may be situations in which business interruption insurance is paid as an advance, lump-sum, nonrefundable final settlement amount for both future estimated fixed costs (e.g., continued labor, utilities) and estimated future lost profit margin for a claim period that covers future reporting periods. Under these circumstances, the amount received in advance related to future estimated fixed costs or future estimated lost profit margin is treated as a gain contingency. Therefore, because the advanced payment is final and nonrefundable, the gain is considered realized even though the future fixed costs or lost profit margin has not yet occurred. There is no remaining contingency; the gain is therefore recognized in the financial statements given that there is no basis to defer and amortize the insurance proceeds over the future anticipated periods of continuing fixed costs or lost profit margin.

**Example 4-6**

**Recognition of Business Interruption Insurance Proceeds**

On January 7, 20X1, a fire severely damages Company W's retail store, resulting in impaired operations and lost profits. Company W maintains insurance coverage to cover business interruption losses, including both fixed costs incurred and profits lost during the inoperable period. The insurance policy coverage period is from January 1, 20X1, to December 31, 20X1. Company W expects that the retail store will be closed until at least the second quarter of 20X2.

Company W's insurance policy covers $100,000 of continued fixed costs and lost profits during the inoperable period, but the policy does not bifurcate the $100,000 between the two categories. In addition, W estimates that for the remainder of 20X1, its continued fixed costs will be $100,000, and its lost profits will be $150,000.

During the period from January 7, 20X1, to April 30, 20X1, the date W issues its first-quarter financial statements, W and its insurer have ongoing discussions regarding the accuracy of W's estimates of continuing fixed costs and lost profits expected through December 31, 20X1. Company W believes as of April 30, 20X1, that it is probable that it will receive insurance proceeds of the full $100,000 policy; however, the insurer has not distinguished what portion of the probable $100,000 payment should be allocated to the expected continuing fixed costs (which includes certain fixed costs incurred and recognized in the first-quarter financial statements) or to the estimated lost profits in the period from January 7, 20X1, to December 31, 20X1.

In its first-quarter financial statements, W concludes that the entire probable insurance payment can be attributed to an indeterminable mix of (1) previously recognized fixed costs recognized during the first quarter, (2) estimated future fixed costs to be incurred, and (3) estimated lost profits during the first quarter and through the end of December 31, 20X1. Therefore, W accounts for the entire amount as a gain contingency and does not recognize any amount as a recovery receivable asset given that payment is not realized or realizable.
Example 4-6 (continued)

On June 30, 20X1, the insurer pays W the entire $100,000 and communicates to W that the payment is nonrefundable and no contingencies remain related to the policy period through December 31, 20X1 (e.g., no remaining due diligence is to be performed by the insurer). The insurer also communicates to W that the $100,000 is allocated in the following manner:

- $50,000 to fixed costs incurred through June 30, 20X1.
- $25,000 to estimated fixed costs to be incurred from July 1, 20X1, to December 31, 20X1.
- $10,000 to estimated lost profits during the period of January 7, 20X1, to June 30, 20X1.
- $15,000 to estimated lost profits during the period from July 1, 20X1, to December 31, 20X1.

In its June 30, 20X1, financial statements, W recognizes the entire $100,000 insurance payment in income. Because all contingencies have been resolved upon receipt of the payment, the gain contingency is considered realized and should be recognized in the financial statements at that time without deferral over the remaining periods of estimated fixed costs to be incurred and future estimated lost profits. Although W predicts that the retail store will be inoperable until the second quarter of 20X2, it would not be appropriate for W to recognize the proceeds over the remaining period of inoperability or the remaining period in the policy through December 31, 20X1, because the final settlement received on June 30, 20X1, is no longer a contingency.

ASC 220-30-45-1 addresses the income statement presentation related to business interruption insurance and allows an entity to “choose how to classify business interruption insurance recoveries in the statement of operations, as long as that classification is not contrary to existing generally accepted accounting principles (GAAP).” In addition, in a period in which business interruption insurance recoveries are recognized, ASC 220-30-50-1 requires further disclosures in the notes to financial statements.

4.7 Balance Sheet Presentation — Offsetting

An entity that purchases insurance from a third-party insurer generally remains primarily obligated for insured liabilities; however, the entity should carefully evaluate the insurance contract and applicable laws. Under U.S. GAAP, offsetting assets and liabilities is appropriate only when a right of setoff exists.

ASC 210-20-20 defines the right of setoff as “a debtor's legal right, by contract or otherwise, to discharge all or a portion of the debt owed to another party by applying against the debt an amount that the other party owes to the debtor.” A receivable for a probable insurance recovery should not be offset against the associated liability for balance sheet classification purposes unless all four of the criteria in ASC 210-20-45-1 are met.
A right of setoff exists when all of the following conditions are met:

- Each of two parties owes the other determinable amounts.
- The reporting party has the right to set off the amount owed with the amount owed by the other party.
- The reporting party intends to set off.
- The right of setoff is enforceable at law.

It is not appropriate to offset insurance recoveries against liabilities recorded in accordance with ASC 450 unless the requirements of ASC 210-20 are met. In most situations, we believe that a right of setoff would not exist under ASC 210-20 because, generally, an insurance receivable and claim liability would be with different counterparties. For example, insurance proceeds received by the reporting entity are usually from a third-party insurer, whereas the contingent liability related to claim liabilities would be to a party other than the third-party insurer.

If criteria (a), (b), and (d) in ASC 210-20-45-1 are met, an offsetting presentation in the financial statements is not representationally faithful when a right to offset exists but the entity does not intend to set off, as noted in criterion (c). Acknowledgment of the intent to set off by the reporting entity and, if applicable, demonstration of the execution of the setoff in similar situations could satisfy criterion (c).

### 4.8 Income Statement Classification of Loss Recoveries and Gain Contingencies

As discussed in Section 4.6, ASC 220-30-45-1 addresses the income statement presentation related to business interruption insurance and allows an entity to “choose how to classify business interruption insurance recoveries in the statement of operations, as long as that classification is not contrary to existing generally accepted accounting principles (GAAP).” Further, ASC 410-30 provides guidance on the income statement presentation of environmental remediation costs and related recoveries, such as insurance recoveries. ASC 410-30-45-4 states that “environmental remediation-related expenses shall be reported as a component of operating income in income statements that classify items as operating or nonoperating. Credits arising from recoveries of environmental losses from other parties shall be reflected in the same income statement line.”

Although authoritative income statement classification guidance does not exist for many other types of loss recoveries, such as involuntary conversions, we believe that entities in practice have generally applied the guidance in ASC 410-30 by analogy when determining the appropriate classification of other loss recoveries.

For recoveries in which the recovery proceeds exceed the incurred loss, resulting in a gain, an entity should consider other authoritative literature, including applicable SEC requirements such as SEC Regulation S-X, when determining whether classification of the gain within the related income statement line item as the loss recovery is appropriate. Depending on the nature of the gain, entities should consider whether the appropriate classification is operating or nonoperating. We believe that entities should provide sufficient disclosure, if material, to enable a financial statement user to determine in which financial statement line item the gain has been recognized.
4.9 Statement of Cash Flows Classification of Insurance Proceeds

ASC 230-10-45-21B states that “[c]ash receipts resulting from the settlement of insurance claims, excluding proceeds received from corporate-owned life insurance policies and bank-owned life insurance policies, shall be classified on the basis of the related insurance coverage (that is, the nature of the loss).” In addition, for lump-sum settlements, “an entity shall determine the classification on the basis of the nature of each loss included in the settlement.”

Entities should determine the classification of insurance receipts that have aspects of more than one class of cash flows by first applying specific guidance in U.S. GAAP. When such guidance is not available, financial statement preparers should separate each identifiable source of cash flows on the basis of the nature of the underlying cash flows. Each separately identified source of cash receipts should then be classified on the basis of its nature. Classification based on the activity that is most likely to be the predominant source or use of cash flows is appropriate only when the source of insurance receipts has multiple characteristics and is not separately identifiable. For additional information on the determination of more than one class of cash flows, see Section 6.4 of Deloitte’s A Roadmap to the Preparation of the Statement of Cash Flows.

For example, insurance settlement proceeds received as a result of a claim made in connection with the destruction of productive assets should be classified as cash inflows from investing activities because the settlement proceeds could be analogous to proceeds received on the sale of such assets. However, proceeds received as a result of claims related to a business interruption should be classified as operating activities.

Example 4-7

Business Interruption Cash Flow Classification

A flash flood destroys a fleet of RVs and a building at the corporate headquarters of RV Company XYZ, leaving the RV dealer inoperable for three months until it can restock its inventory and repair the corporate headquarters. RV Company XYZ has property and business interruption insurance that covers lost profit margins, lost inventory, and damaged equipment and property. Covered losses under the insurance policy include natural disasters, such as floods. RV Company XYZ receives a lump-sum insurance payment of $85 for lost profit margin, lost RV inventory, and corporate headquarters repairs. In a manner consistent with the submitted claim, XYZ determines that $15 should be allocated to lost profit margin, $45 to damaged inventory, and $25 to rebuilding a portion of the corporate headquarters.

RV Company XYZ appropriately classifies the insurance receipt in the statement of cash flows as follows:

- $15 lost profit margin = operating inflow.
- $45 lost inventory = operating inflow.
- $25 corporate headquarters reconstruction = investing inflow.

4.10 Subsequent-Event Considerations

Entities should evaluate events that occur after the balance sheet date but before the financial statements are issued or are available to be issued to determine whether the events should be recognized in the current-period financial statements or in the subsequent-period financial statements.

The recognition, measurement, and disclosure principles related to loss recoveries that are described in this chapter apply to the period after the balance sheet date but before the financial statements are issued or are available to be issued.
After the balance sheet date, there may be a recovery of a loss that exceeds the amount of a loss previously recognized on or before the balance sheet date, resulting in a gain after the balance sheet date. The recovery should be treated as two separate units of account:

- **Loss recovery** — The amount of the recovery equal to the previously recognized loss.
- **Gain contingency** — The amount of the recovery in excess of the previously recognized loss.

The recognition of these two units of account will differ in a manner that is consistent with the different loss recovery models described in this chapter. A recovery asset (e.g., a receivable) for the amount of the recovery equal to the previously recognized loss should be accounted for as a recognized or nonrecognized subsequent event in a manner that is consistent with the recognition threshold for loss contingencies.

If an event occurs after the balance sheet date but before the financial statements are issued or are available to be issued, and the event indicates that a loss recovery is probable (or the loss recovery has been received) for a loss incurred on or before the balance sheet date, the event provides additional evidence of the recovery and should be accounted for as a recognized subsequent event. Examples might include (1) the probable receipt of insurance proceeds equaling the loss incurred related to a plant that was destroyed on or before the balance sheet date or (2) proceeds from a lawsuit settlement in the amount of a previous loss incurred for litigation that arose on or before the balance sheet date.

The amount of the recovery in excess of the previously recognized loss would generally be accounted for as a nonrecognized subsequent event because to realize the gain recovery would be to recognize revenue before it is realized as described in ASC 450-30-25-1. Accounting for the two units of account by using separate recognition thresholds is consistent with the subsequent-event treatment of loss contingencies and gain contingencies discussed earlier in this Roadmap. Further, the treatment of the loss recovery and the gain contingency as two separate units of account is consistent with the involuntary conversion guidance in Section 4.2.

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**Example 4-8**

**Accounting for Insurance Proceeds Comprising a Loss Recovery and a Gain Contingency**

Company P is a public company with a calendar year-end of December 31, 20X8. On December 24, 20X8, a flood severely damages P's operating plant. Company P determines that it has incurred a loss of $500,000 because of the flood damage and therefore recognizes the $500,000 loss as of December 31, 20X8. On February 19, 20X9, before the issuance of P's financial statements, the insurance company notifies P that it will pay insurance proceeds in the amount of $750,000, subject to the completion of the insurance company's investigation process.

Company P has previously received insurance proceeds from this insurance company related to other damages and is therefore familiar with the ongoing investigation process. Company P determines that it is probable that the investigation will not change the anticipated recovery of $750,000. Therefore, as of December 31, 20X8, P recognizes a loss recovery asset as a recognized subsequent event in the amount of $500,000, which is the amount equal to the previously recognized loss. The remaining $250,000 is subject to the gain contingency guidance, and therefore, the notion of probability is irrelevant. Since there are unresolved contingencies as of the balance sheet date of December 31, 20X8 (i.e., the ongoing investigation), the $250,000 does not reach the gain contingency recognition threshold described in Chapter 3 and therefore constitutes a nonrecognized subsequent event and should not be recorded as of December 31, 20X8.
Appendix A — Differences Between U.S. GAAP and IFRS Standards

The primary sources of guidance on the accounting for contingencies are ASC 450 under U.S. GAAP and IAS 37 under IFRS Standards. Throughout this appendix, terminology applicable to both U.S. GAAP and IFRS Standards is used, depending on the applicable guidance (e.g., “contingent gain” in U.S. GAAP versus “contingent asset” in IFRS Standards).

The table below summarizes commonly encountered differences between the accounting for contingencies under U.S. GAAP and that under IFRS Standards. For detailed interpretive guidance on IAS 37, see Chapter A12, “Provisions, Contingent Liabilities and Contingent Assets,” of Deloitte’s iGAAP publication.

<table>
<thead>
<tr>
<th>Subject</th>
<th>U.S. GAAP</th>
<th>IFRS Standards</th>
</tr>
</thead>
<tbody>
<tr>
<td>Terminology</td>
<td>Three categories:</td>
<td>Three categories:</td>
</tr>
<tr>
<td></td>
<td>• Estimated loss accrued for a loss contingency (i.e., a contingent loss that is recognized as a liability).</td>
<td>• Provision is an accrued liability or loss contingency recognized in the financial statements.</td>
</tr>
<tr>
<td></td>
<td>• Contingent loss that is not recognized as a liability (e.g., when a contingent loss cannot be reasonably estimated).</td>
<td>• Contingent liability is a loss contingency that does not meet the criteria to be recognized in the financial statements.</td>
</tr>
<tr>
<td></td>
<td>• Contingent gain.</td>
<td>• Contingent asset is a concept similar to contingent gains under U.S. GAAP.</td>
</tr>
</tbody>
</table>

U.S. GAAP and IFRS Standards use different terminology to describe contingencies. Under U.S. GAAP, this terminology is related to financial statements’ elements of performance (two key terms are “contingent gain” and “contingent loss”), whereas under IFRS Standards, the terminology used is related to financial statements’ elements of financial position (the three key terms are “contingent asset,” “contingent liability,” and “provision”). However, the two sets of terms may be applied similarly so that no difference between them arises in practice.

<table>
<thead>
<tr>
<th>Recognition of contingent losses/provisions</th>
<th>U.S. GAAP</th>
<th>IFRS Standards</th>
</tr>
</thead>
<tbody>
<tr>
<td>One of the conditions for loss accrual is</td>
<td>that it is probable that (1) an asset has been impaired or (2) a liability has been incurred. “Probable” is defined as “likely to occur” (i.e., generally greater than 70 percent), which is a higher threshold than “more likely than not” (i.e., greater than 50 percent).</td>
<td>One of the conditions for recognizing a provision (as a liability) is that it is probable that an outflow of resources will be required to settle the obligation. “Probable” is defined as “more likely than not” (i.e., greater than 50 percent). More contingencies may qualify for recognition as liabilities under IFRS Standards than under U.S. GAAP.</td>
</tr>
</tbody>
</table>
(Table continued)

<table>
<thead>
<tr>
<th>Subject</th>
<th>U.S. GAAP</th>
<th>IFRS Standards</th>
</tr>
</thead>
<tbody>
<tr>
<td>Measurement of contingent losses/ provisions — range of estimates</td>
<td>If no amount in the range is more likely than any other amount in the range, the <strong>minimum</strong> amount in the range is used to measure the amount to be accrued for a loss contingency.</td>
<td>If no amount in the range is more likely than any other amount in the range, the <strong>midpoint</strong> of the range is used to measure the liability.</td>
</tr>
<tr>
<td>Measurement of contingent losses/ provisions — discounting</td>
<td>Discounting is permitted only when the timing of related cash flows is fixed or reliably determinable.</td>
<td>Discounting is required if the effect of discounting is material.</td>
</tr>
<tr>
<td>Onerous contracts</td>
<td>Losses on firmly committed onerous contracts are usually not recognized. See Section 2.2.1 for additional discussion.</td>
<td>Under IFRS Standards, an entity is required to recognize and measure the present obligation under an onerous contract as a provision (paragraphs 66 through 69 of IAS 37). An onerous contract is one “in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. The unavoidable costs under a contract reflect the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfill it.”</td>
</tr>
<tr>
<td>Disclosure of prejudicial information</td>
<td>Exemptions from disclosure of information that may be prejudicial to an entity are not permitted.</td>
<td>In extremely rare cases, if disclosure of certain information could prejudice the position of the entity in a dispute with other parties, that information does not need to be disclosed. However, an entity must disclose the nature of the dispute, along with the reason why the information has not been disclosed.</td>
</tr>
<tr>
<td>Gain contingencies (U.S. GAAP) versus contingent assets (IFRS Standards)</td>
<td>At the earlier of when a gain contingency is realized or becomes realizable, recognition is appropriate.</td>
<td>When realization of a contingent asset is virtually certain, recognition is appropriate. Because the thresholds between U.S. GAAP and IFRS Standards are very similar, no differences are expected to arise in practice.</td>
</tr>
</tbody>
</table>
Appendix B — Titles of Standards and Other Literature

The following are the titles of standards and other literature mentioned in this publication:

**AICPA Literature**

**Clarified Statements on Auditing Standards**
AU-C Section 501, “Audit Evidence — Specific Considerations for Selected Items”
AU-C Section 620, “Using the Work of an Auditor’s Specialist”

**Issues Paper**
*The Use of Discounting in Financial Reporting for Monetary Items With Uncertain Terms Other Than Those Covered by Existing Authoritative Literature*

**FASB Literature**

**ASC Topics**
ASC 210, *Balance Sheet*
ASC 220, *Income Statement — Reporting Comprehensive Income*
ASC 230, *Statement of Cash Flows*
ASC 250, *Accounting Changes and Error Corrections*
ASC 270, *Interim Reporting*
ASC 275, *Risks and Uncertainties*
ASC 310, *Receivables*
ASC 326, *Financial Instruments — Credit Losses*
ASC 330, *Inventory*
ASC 340, *Other Assets and Deferred Costs*
ASC 360, *Property, Plant, and Equipment*
ASC 405, *Liabilities*
ASC 410, *Asset Retirement and Environmental Obligations*
ASC 420, *Exit or Disposal Cost Obligations*
ASC 440, *Commitments*
ASC 450, Contingencies
ASC 460, Guarantees
ASC 470, Debt
ASC 605, Revenue Recognition
ASC 606, Revenue From Contracts With Customers
ASC 610, Other Income
ASC 705, Cost of Sales and Services
ASC 710, Compensation — General
ASC 712, Compensation — Nonretirement Postemployment Benefits
ASC 715, Compensation — Retirement Benefits
ASC 718, Compensation — Stock Compensation
ASC 720, Other Expenses
ASC 740, Income Taxes
ASC 805, Business Combinations
ASC 815, Derivatives and Hedging
ASC 835, Interest
ASC 840, Leases
ASC 842, Leases
ASC 855, Subsequent Events
ASC 860, Transfers and Servicing
ASC 930, Extractive Activities — Mining
ASC 944, Financial Services — Insurance
ASC 946, Financial Services — Investment Companies
ASC 954, Health Care Entities

ASUs
ASU 2014-15, Presentation of Financial Statements — Going Concern (Subtopic 205-40): Disclosure of Uncertainties About an Entity’s Ability to Continue as a Going Concern
ASU 2016-13, Financial Instruments — Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments

Concepts Statements
No. 5, Recognition and Measurement in Financial Statements of Business Enterprises
No. 6, Elements of Financial Statements
No. 7, Using Cash Flow Information and Present Value in Accounting Measurements
Proposed ASU
No. 1840-100, Contingencies (Topic 450): Disclosure of Certain Loss Contingencies

International Standard
IAS 37, Provisions, Contingent Liabilities and Contingent Assets

SEC Literature

Regulation S-K
Item 303, “Management's Discussion and Analysis of Financial Condition and Results of Operations”

SAB Topics
No. 5.N, “Discounting by Property-Casualty Insurance Companies”
No. 5.Y, “Accounting and Disclosures Relating to Loss Contingencies”

Superseded Literature

AICPA Accounting Research Bulletin (ARB)
No. 50, Contingencies

EITF Literature
Issue No. 00-21, “Revenue Arrangements With Multiple Deliverables”
Issue No. 00-26, “Recognition by a Seller of Losses on Firmly Committed Executory Contracts”
Issue No. 01-10, “Accounting for the Impact of the Terrorist Attacks of September 11, 2001”
Issue No. 03-17, “Subsequent Accounting for Executory Contracts That Have Been Recognized on an Entity’s Balance Sheet”
Issue No. 99-14, “Recognition by a Purchaser of Losses on Firmly Committed Executory Contracts”

FASB Interpretations
No. 14, Reasonable Estimation of the Amount of a Loss — an interpretation of FASB Statement No. 5
No. 47, Accounting for Conditional Asset Retirement Obligations — an interpretation of FASB Statement No. 143
No. 48, Accounting for Uncertainty in Income Taxes — an interpretation of FASB Statement No. 109

FASB Statements
No. 5, Accounting for Contingencies
No.109, Accounting for Income Taxes
No. 114, Accounting by Creditors for Impairment of a Loan
No. 143, Accounting for Asset Retirement Obligations
## Appendix C — Abbreviations

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tbody>
<tr>
<td>AICPA</td>
<td>American Institute of Certified Public Accountants</td>
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<tr>
<td>ARB</td>
<td>Accounting Research Bulletin</td>
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<tr>
<td>ASC</td>
<td>FASB Accounting Standards Codification</td>
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<tr>
<td>ASU</td>
<td>FASB Accounting Standards Update</td>
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<tr>
<td>CECL</td>
<td>current expected credit loss</td>
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<tr>
<td>CFO</td>
<td>chief financial officer</td>
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<tr>
<td>EITF</td>
<td>Emerging Issues Task Force</td>
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<tr>
<td>FASB</td>
<td>Financial Accounting Standards Board</td>
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<tr>
<td>FDA</td>
<td>U.S. Food and Drug Administration</td>
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<tr>
<td>FIN</td>
<td>FASB Interpretation</td>
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<tr>
<td>GAAP</td>
<td>generally accepted accounting principles</td>
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<tr>
<td>IBNR</td>
<td>incurred but not reported</td>
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<tr>
<td>ICFR</td>
<td>internal control over financial reporting</td>
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<tr>
<td>IFRS</td>
<td>International Financial Reporting Standard</td>
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<tr>
<td>IPO</td>
<td>initial public offering</td>
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<tr>
<td>LIFO</td>
<td>last in, first out</td>
</tr>
<tr>
<td>MD&amp;A</td>
<td>Management's Discussion and Analysis</td>
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<tr>
<td>PBE</td>
<td>public business entities</td>
</tr>
<tr>
<td>PCAOB</td>
<td>Public Company Accounting Oversight Board</td>
</tr>
<tr>
<td>SEC</td>
<td>Securities and Exchange Commission</td>
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