

## **Week 4 - DQ 2**

***The two basic requirements for the accrual of a loss contingency are supported by several basic concepts of accounting. Four of these concepts are periodicity (time periods), measurement, objectivity, and relevance.***

***Discuss how the two basic requirements for accrual of a loss contingency relate to the four concepts listed above.***

### ***Response #1***

A loss contingency is a possible loss or expense stemming from past events that will be resolved as to existence and amount by some future event. Loss contingencies are accrued if it is probable that a loss has been incurred and the amount of loss can be estimated reasonably. Even if these conditions are met, loss contingencies should be disclosed if it is reasonably possible that a material loss has been incurred.

### ***Response #2***

According to SFAC 5, an item should be recognized in the basic financial statements when it meets the following four criteria, subject to a cost effectiveness constraint and materiality threshold:

1. **Definition.** The item meets the definition of an element of financial statements.
2. **Measurability.** The item has a relevant attribute measurable with sufficient reliability. The question of measurement involves two choices: (1) the choice of a unit of measurement, and (2) the choice of an attribute to be measured. SFAC 5 essentially confirmed existing practice in both of these areas.
3. **Relevance.** The information about it is capable of making a difference in user decisions.
4. **Reliability.** The information is representational faithful, verifiable, and neutral. IASB Exposure Draft on Contingent Assets and Liabilities
  - Eliminates concept of "contingent liability"

- Recognition: Recognize all present obligations arising from past events (a/k/a obligating events)
- Measurement: uncertainties regarding amount or timing of payment are reflected in the measurement of the liability; measure at present value of probability weighted expected cash flows
- Disclosure: disclose amount, description, reconciliation, timing, uncertainties, and potential recoveries

Reference: <http://highered.mcgraw-hill.com/sites/0072994029>

### ***Response #3***

We discussed earlier in the week about contingencies and that there are two types of contingencies. The two type are gains and losses and while both could be relevant here we will discuss the losses because, while both are important, potential losses are to be annotated in the financial statements. Four concepts will be covered to discuss the relevance of each to contingencies within an organization.

There are three types of time periods and measurements that we can look at for losses. The three types are probable, reasonably probable, and remote. These three types describe the possibility of losses occurring and a measurement of the possibility. In addition to the type reasonable efforts should be put forth to measure the potential loss for managers and investors to assess and in a timely manner. The information presented to managers and investors should also remain free of any biases and just stick to the facts of the potential loss. Finally, the information needs to be relevant for decisions to be made. Potential losses need to be calculated for now and not based on something that has happened in the past.

Each of the concepts listed relate to traits of honesty that any business should follow. Information, whether good or bad, should always be presented as it is to managers and investors in order to make the best decisions for a company.

### ***Response #4***

The two basic requirements for accrual of a loss contingency are: probable and reasonably possible that a loss contingency will be incurred. After the determination has been made that a loss contingency will be incurred and the time period in which the loss contingency is incurred relative to the date of the financial statements. This makes the information relevant to the users of financial information for decision-making purposes. In addition, the information can be measured and provides objective data for the financial statements.