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The Clear-Cut: ASPE

Disclosure of Contingencies

The March 2019 update to the CPA Canada Standards and Guidance collection included updates to *CAS 540, Auditing Accounting Estimates and Related Disclosures*. The updates are fairly straight forward, and are effective for audits for periods beginning on or after December 15, 2019. Nevertheless, we wanted to review estimates and disclosures of contingencies in this Clear-Cut to assist practitioners, engaged to perform any assurance level engagement, with the various estimates and judgments to be considered when dealing with contingencies.

Section 3290 *Contingencies* provides guidance on the recognition, measurement and disclosure of contingencies. Per 3290.5, "*A contingency is an existing condition or situation involving uncertainty as to possible gain or loss to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur*". Contingent liabilities would include, but are not limited to:

- Pending or threatened litigation;
- CRA audit;
- HR complaints; or
- Product deficiencies.

Disclosures of guarantees is covered in an accounting guideline called AcG-14 *Disclosure of guarantees* for which we have a separate Clear-Cut on Disclosures of Guarantees.

Combining the requirements of Section 3290 paragraphs 6 through 24 we can summarize the requirements for contingencies as follows:

Likelihood of Occurrence	Contingent loss can be estimated	Contingent loss cannot be estimated	Contingent gain can be estimated	Contingent gain cannot be estimated
Likely	Accrue 3290.12	Disclose 3290.18	Disclose 3290.22	Disclose 3290.24
Unlikely	Need not disclose	Need not disclose	Do not disclose	Do not disclose
Not determinable	Disclose 32903.12	Disclose 3290.18	Do not disclose	Do not disclose

The prediction of the outcome of the contingencies as well as the estimation of the financial impact lies with management (Section 3290.7), which brings forth a question of potential bias with regards to both the likelihood and the estimation of the amount, but also the specifics and volume of disclosures. Paragraph 19 and 23 put the required disclosures at a minimum of:

a) the nature of the contingency;

b) an estimate of the amount of the contingency or a statement that such an estimate cannot be made; and

c) any exposure to loss in excess of the amount accrued.

Management will likely look towards the assistance of an expert, a lawyer in most cases, to determine the likelihood and amount estimation.

Overall, with considerations for the inherent risk, estimation uncertainty, judgments, management experts, financial statement disclosures, and file documentation, contingencies can be tough to traverse and should not be taken lightly.

Illustrative Example:

Suppose a lawsuit is filed against your client, and the plaintiff, claims $50,000 for product deficiencies. When discussing the claim with legal counsel, the lawyer notes that the company is likely to lose the suit, but in his assessment, the estimated payout would be $20,000. In this scenario, given that the occurrence of a loss is likely and the loss can be estimated, you would be required to accrue the estimated payout as per Section 3290.12.

Accounting entry:

Debit - Legal expense	*$20,000*	
Credit - Accrued liability		*$20,000*

Sample disclosure:

<u>Contingent Liability</u>

During the year, the Company received a claim for an alleged product deficiency. The claim seeks damages of $50,000 and the Company is defending the action. Legal advice obtained as at the time the financial statements were prepared indicated that it is likely that the claim could result in an award of $20,000, as such, the Company has accrued this amount as a legal expense in the current year.

NOTE: When using the same facts from the example above, but assuming that your client is the plaintiff instead, the contingent gain would only be disclosed and not accrued.