UNIT 5 : CONTINGENT ASSETS AND CONTINGENT LIABILITIES

LEARNING OUTCOMES

After studying this unit, you will be able to:

- Understand the meaning of the terms 'Contingent Assets' and 'Contingent Liabilities'.
- Distinguish 'Contingent Liabilities' with 'Liabilities' and 'Provisions'

UNIT OVERVIEW

Contingent Asseet

- A possible asset arises from past events and their existence will be confirmed only after occurrence or non-occurrence of one or more uncertain future events.

Contingent Liability

- A possible obligation arising from past events and may arise in future depending on the occurrence or non-occurrence of one or more uncertain future events.

5.1 CONTINGENT ASSET

A contingent asset may be defined as a possible asset that arises from past events and whose existence will be confirmed only after occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise. It usually arises from unplanned or unexpected events that give rise to the possibility of an inflow of economic benefits to the business entity. For example, a claim that an enterprise is pursuing through legal process, where the outcome is uncertain, is a contingent asset.

As per the concept of prudence as well as the present accounting standards, an enterprise should not recognise a contingent asset. These assets are uncertain and may arise from a claim which an enterprise pursues through a legal proceeding. There is uncertainty in realisation of claim. It is possible that recognition of contingent assets may result in recognition of income that may never be realised. However, when the realisation of income is virtually certain, then the related asset no longer remains as contingent asset.

A contingent asset need not be disclosed in the financial statements. A contingent asset is usually disclosed in the report of the approving authority (Board of Directors in the case of a company, and the corresponding approving authority in the case of any other enterprise), if an inflow of economic benefits is probable. Contingent assets are assessed continually and if it has become virtually certain that an inflow of economic benefits will arise, the asset and the related income are recognised in the financial statements of the period in which the change occurs.

5.2 CONTINGENT LIABILITIES

The term 'Contingent liability' can be defined as

"(a) a possible obligation1 that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or

(b) a present obligation 2 that arises from past events but is not recognised because:

  (i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or

  (ii) a reliable estimate of the amount of the obligation cannot be made."

A contingent liability is a possible obligation arising from past events and may arise in future depending on the occurrence or non-occurrence of one or more uncertain future events [part (a) of the definition]. A contingent liability may also be a present obligation that arises from past events [(part (b) of the definition)].

An enterprise should not recognise a contingent liability. A Contingent liability is required to be disclosed unless possibility of outflow of a resource embodying economic benefits is remote. These liabilities are assessed continually to determine whether an outflow of resources embodying economic benefits has become probable. If it becomes probable that an outflow or future economic benefits will be required for an item previously dealt with as a contingent liability, a provision is recognised in financial statements of the period in which the change in probability occurs except in the extremely rare circumstances where no reliable estimate can be made.

5.3 DISTINCTION BETWEEN CONTINGENT LIABILITIES AND LIABILITIES

The distinction between a liability and a contingent liability is generally based on the judgement of the management. A liability is defined as the present financial obligation of an enterprise, which arises from past events. The settlement of a liability results in an outflow from the enterprises of resources embodying economic benefits. On the other hand, in the case of contingent liability, either outflow of resources to settle the obligation is not probable or the amount expected to be paid to settle the liability cannot be measured with sufficient reliability. Examples of contingent liabilities are claims against the enterprise not acknowledged as debts, guarantees given in respect of third parties, liability in respect of bills discounted and statutory liabilities under dispute etc. In addition to present obligations that are recognized as liabilities in the balance sheet, enterprises are required to disclose contingent liability in their balance sheets by way of notes.

5.4 DISTINCTION BETWEEN CONTINGENT LIABILITIES AND PROVISIONS

Provision means "any amount written off or retained by way of providing for depreciation, renewal or diminution in the value of assets or retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy".

It is important to know the difference between provisions and contingent liabilities. The distinction between both of them can be explained as follows:

	Provision	Contingent liability
(1)	Provision is a present liability of uncertain amount, which can be measured reliably by using a substantial degree of estimation.	A Contingent liability is a possible obligation that may or may not crystallise depending on the occurrence or non-occurrence of one or more uncertain future events.
(2)	A provision meets the recognition criteria.	A contingent liability fails to meet the same.
(3)	Provision is recognised when (a) an enterprise has a present obligation arising from past events; an outflow of resources embodying economic benefits is probable, and (b) a reliable estimate can be made of the amount of the obligation.	Contingent liability includes present obligations that do not meet the recognition criteria because either it is not probable that settlement of those obligations will require outflow of economic benefits, or the amount cannot be reliably estimated.
(4)	If the management estimates that it is probable that the settlement of an obligation will result in outflow of economic benefits, it recognises a provision in the balance sheet.	If the management estimates, that it is less likely that any economic benefit will outflow the firm to settle the obligation, it discloses the obligation as a contingent liability.

Let us take an example to understand the distinction between provisions and contingent liabilities. The Central Excise Officer imposes a penalty on Alpha Ltd. for violation of a provision in the Central Excise Act. The company goes on an appeal. If the management of the company estimates that it is probable that the company will have to pay the penalty, it recognises a provision for the liability. On the other hand, if the management anticipates that the judgement of the appellate authority will be in its favour and it is less likely that the company will have to pay the penalty, it will disclose the obligation as a contingent liability instead of recognising a provision for the same.

TEST YOUR KNOWLEDGE

Mutiple Choice Questions

1. (i) Contingent asset usually arises from unplanned or unexpected events that give rise to

   (a) The possibility of an inflow of economic benefits to the business entity.

   (b) The possibility of an outflow of economic benefits to the business entity.

   (c) Either (a) or (b).

   (ii) If an inflow of economic benefits is probable then a contingent asset is disclosed

   (a) In the financial statements.

   (b) In the report of the approving authority (Board of Directors in the case of a company, and the corresponding approving authority in the case of any other enterprise).

   (c) In the cash flow statement.

(iii) In the case of ____________, either outflow of resources to settle the obligation is not probable or the amount expected to be paid to settle the liability cannot be measured with sufficient reliability.

(a) Liability (b) Provision

(c) Contingent liabilities

(iv) Present liability of uncertain amount, which can be measured reliably by using a substantial degree of estimation is termed as _________.

(a) Provision. (b) Liability.

(c) Contingent liability.

(v) In the financial statements, contingent liability is

(a) Recognised. (b) Not recognised.

(c) Adjusted.

Theoretical Questions

1. Differentiate between:

   (i) Provision and Contingent Liability.

   (ii) Liability and Contingent liability.

ANSWERS/HINTS

Multiple Choice Questions

(i) (a) (ii) (b) (iii) (c) (iv) (a) (v) (b)

Theoretical Questions

1. Provision is a present liability of uncertain amount, which can be measured reliably by using a substantial degree of estimation. On the other hand, a Contingent liability is a possible obligation that may or may not crystallize depending on the occurrence or non-occurrence of one or more uncertain future events.

2. A liability is defined as the present financial obligation of an enterprise, which arises from past events. On the other hand, in the case of contingent liability, either outflow of resources to settle the obligation is not probable or the amount expected to be paid to settle the liability cannot be measured with sufficient reliability.