Chapter 27

CONTINGENT ASSETS AND LIABILITIES

1. Contingent liability

A **contingent liability** is a possible liability arising from past events but the existence of that liability will only be confirmed by future events.

Note it's very important that the possible liability arises from **past events.** We are not trying to foresee events which may arise in the future and which give rise to liabilities.

The treatment of the liability depends on how probable it is that there will be an outflow resources from the company:

- If the present obligation probably requires the outflow of resources then a provision is recognised and disclosures are required. In other words an expense account could be debited and some sort of accrual or liability account will be credited.
- If it is a possible obligation that will probably not require the outflow resources, no provision is required but disclosure should be made by way of notes.
- If the outflow of resources is remote, in other words very unlikely, no provision and no disclosure is required.

A good example of contingent liability is a legal action arising from some past event: if it is probable that you are going to have to pay up, set up a provision; if it's merely possible you have to pay up, no provision is needed but the risk should be disclosed. If it is very unlikely that you are going to have to pay up, no provision and no disclosure.

It can be difficult to assess probability of a liability actually crystallizing and auditors will have to review correspondence with, for example, solicitors and also look at board minutes.

2. Contingent asset

Contingent asset is a possible asset arising from past events but whose existence will only be confirmed by future events.

The treatment of contingent asset is very similar to that of contingent liabilities, but slightly more cautious.

- If an inflow of economic benefits is virtually certain then the asset is not contingent: it's a real asset and should be showed in the statement of financial position.
- If the inflow of economic benefits is merely probable, not virtually certain, then it would be imprudent to recognise that asset in the balance sheet but disclosures by way of note will be useful and therefore should be made.
- If the inflow is not probable, then it would not make sense to recognise the asset or to give any type of disclosure.

Note that the treatment of contingent assets and liabilities though similar is not identical:

Contingent liability	Contingent asset	Treatment
Probable outflow of resources	Virtually certain inflow of benefits	Recognise fully in the financial statements
Possible outflow of resources	Probable inflow of resources	Disclose by way of note
Remote likelihood of outflow of resources	Not probable inflow of resources	No disclosure of any kind

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