KPMG

Contingencies, commitments and guarantees

Handbook



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The art and science of accounting for contingencies

Companies are frequently faced with contingencies. While the applicable guidance in the area has survived the test of time, the accounting often seems like a rule of thumb exercise guided by the virtues of prudence and transparency.

There are many accounting standards that address specific types of contingencies, and we explain one such standard in this Handbook (Topic 460 on guarantees). We also explain the residual standard used when no other standard applies (Topic 450). As a residual standard, Topic 450 is necessarily general in nature, but long-standing practices have filled in some of its gaps.

These standards require making probability assessments and using estimation methodologies. Fortunately, there is a science to the art of assessing and estimating contingencies, which we endeavor to demonstrate throughout this Handbook as we explain the accounting and disclosure models codified in these standards and developed through the years. We also explain the limited disclosure guidance in Topic 440 on commitments.

We hope you find this Handbook useful when you are tasked with accounting for contingencies.

Valerie Boissou and Lisa Blackburn

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About this publication

This Handbook discusses the accounting for contingencies, guarantees and commitments and the related disclosures. The judgments and complexities related to accounting for uncertainties make applying this guidance challenging.

Organization of the text

Each chapter of this Handbook includes excerpts from the *FASB Accounting Standards Codification*® and overviews of the relevant requirements. Our in-depth guidance is explained through Q&As that reflect the questions we encounter in practice. We include examples to explain key concepts.

Our commentary is referenced to the Codification and to other literature, where applicable. The following are examples.

- 450-20-25-2 is paragraph 25-2 of ASC Subtopic 450-20
- ASU 2016-13.BC97 is paragraph BC97 of Accounting Standards Update No. 2016-13
- CON 8.E60 is paragraph E60 of FASB Concepts Statement No. 8
- FAS 143.BC35 is paragraph 35 of the basis for conclusions in FASB Statement No. 143 (superseded)
- FIN 45.A14 is paragraph A14 of FASB Interpretation No. 45 (superseded)
- IFRS 15 is IFRS® Accounting Standard No. 15
- IAS 37 is International Accounting Standard No. 37
- TQA 3100.01 is section 3100.01 of the AICPA's Technical Questions and Answers
- 2011 AICPA Conf is the 2011 AICPA National Conference on Current SEC and PCAOB Developments
- S-K Item 103(a) is paragraph (a) of Item 103 in SEC Regulation S-K
- S-X Rule 3-01 is Rule 3-01 in SEC Regulation S-X
- Rule 10b-5 is SEC Rule 10b-5
- SAB Topic 5.N is SEC Staff Accounting Bulletin Topic 5.N
- FRR-61 §II.A is Section II.A of SEC Financial Reporting Release 61
- Form 8-K (Item 2.04) is Item 2.04 in SEC Form 8-K

October 2026 edition

The October 2026 edition of our Handbook includes new and updated interpretations based on our experience with companies applying the accounting guidance for contingencies, commitments, and guarantees. Compared to the September 2025 edition, Questions that have been significantly updated or revised are identified with #. The Index of changes identifies all significant changes.

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Pending content

This Handbook incorporates Codification amendments from Accounting Standards Update No. 2023-05, Business Combinations – Joint Venture Formations (Subtopic 805-60): Recognition and Initial Measurement and Update No. 2025-10 – Government Grants (Topic 832): Accounting for Government Grants Received by Business Entities. The amendments are not labeled as pending content.

This Handbook does not incorporate Codification amendments from the following Accounting Standards Updates.

- **No. 2024-03, Income Statement – Reporting Comprehensive Income – Expense Disaggregation Disclosures (Subtopic 220-40): Disaggregation of Income Statement Expenses.** These amendments apply only to public business entities and are effective for annual reporting periods beginning after December 15, 2026, and interim reporting periods within annual reporting periods beginning after December 15, 2027. Early adoption is permitted.
- **No. 2023-06, Disclosure Improvements: Codification Amendments in Response to the SEC's Disclosure Update and Simplification Initiative.** These amendments do not become effective until the SEC removes the related guidance from Regulation S-X or Regulation S-K.

Abbreviations

We use the following abbreviations in this Handbook.

AICPA	American Institute of Certified Public Accountants
EITF	Emerging Issues Task Force
FASB	Financial Accounting Standards Board
IBNR	Incurred but not reported
MD&A	Management's Discussion and Analysis
SEC	Securities and Exchange Commission

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1. Executive summary

This Handbook discusses the accounting for contingencies, guarantees and commitments and the related disclosures. The judgments and complexities related to accounting for uncertainties make applying this guidance challenging.

Contingencies: Key concepts and scope

Subtopic 450-10 establishes the scope for both Subtopic 450-20 (loss contingencies) and Subtopic 450-30 (gain contingencies). Topic 450 applies to all entities.

Loss or gain contingencies

A contingency contains the following three elements.



For a contingency to exist, there must be an existing condition involving uncertainty as to a possible loss or gain that will be resolved when one or more future events occur or fail to occur. The accounting for contingencies often involves estimates; however, measurements of assets and liabilities may require estimates for reasons other than contingencies. For example, if there is nothing uncertain about a liability having been incurred (e.g. services have been received), accrual is required even if the amount and/or timing of settlement are not yet known.

Scope of Topic 450

Topic 450 applies only to contingencies – but not all contingencies are within its scope. When a contingent loss or gain exists, it is not accounted for under Topic 450 if it falls in the scope of another Topic (e.g. asset retirement obligations under Topic 410). There is a long list of contingent losses and gains that are in the scope of other Topics (see Question 2.3.10). Some of these other Topics apply the contingency models in Topic 450 in whole or part.

There are also many instances in which a transaction produces multiple contingencies – some in the scope of Topic 450 and some in the scope of other Topics. For example, natural disasters can create multiple contingencies.

Read more: chapter 2

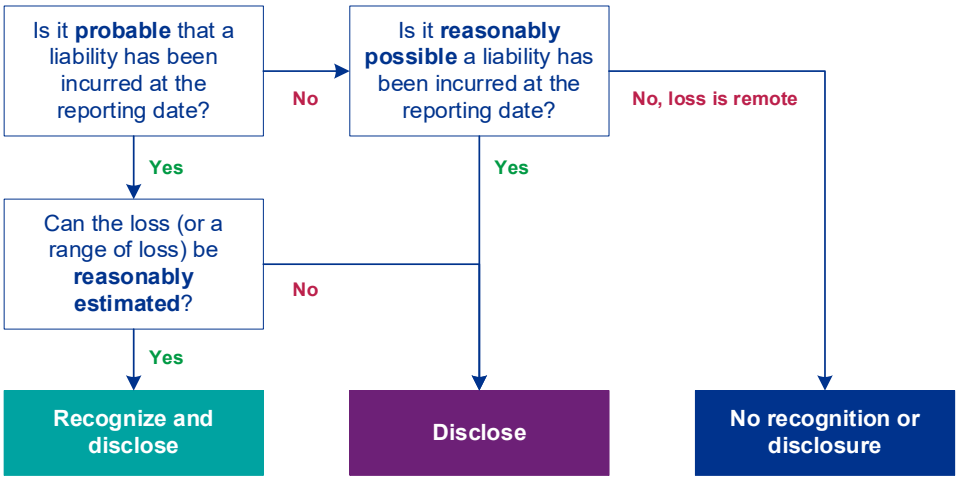
Loss contingencies: Recognition

There are three potential financial reporting outcomes for a loss contingency in the scope of Subtopic 450-20:

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- recognize a loss and disclose;
- do not recognize a loss, but disclose; or
- do not recognize a loss or disclose.

The following decision tree explains which outcome is appropriate in a given situation.

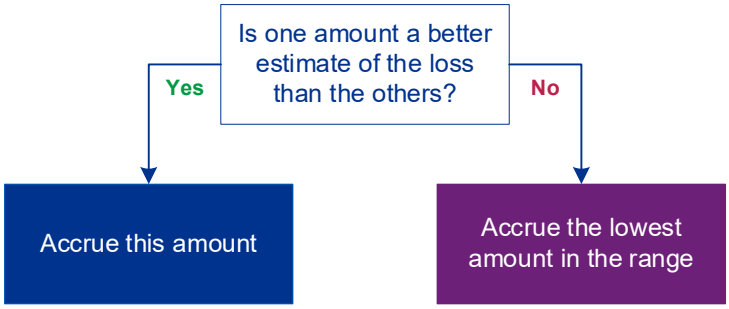


Read more: chapter 3

Loss contingencies: Measurement

When a loss contingency meets the recognition criteria (see chapter 3), it becomes a contingent liability. Subtopic 450-20 requires a contingent liability to be measured based on the best estimate of the ultimate settlement amount. While requiring judgment, this estimate is not based on fair value or expected value techniques. Instead, it is simply based on the amount for which the entity expects to settle the liability.

The process for measuring a contingent liability when there is a range of possible loss is summarized in the following decision tree.



The amount of the loss is monitored and adjusted to reflect information available at each reporting date.

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Loss contingencies: Presentation and disclosure

Presentation

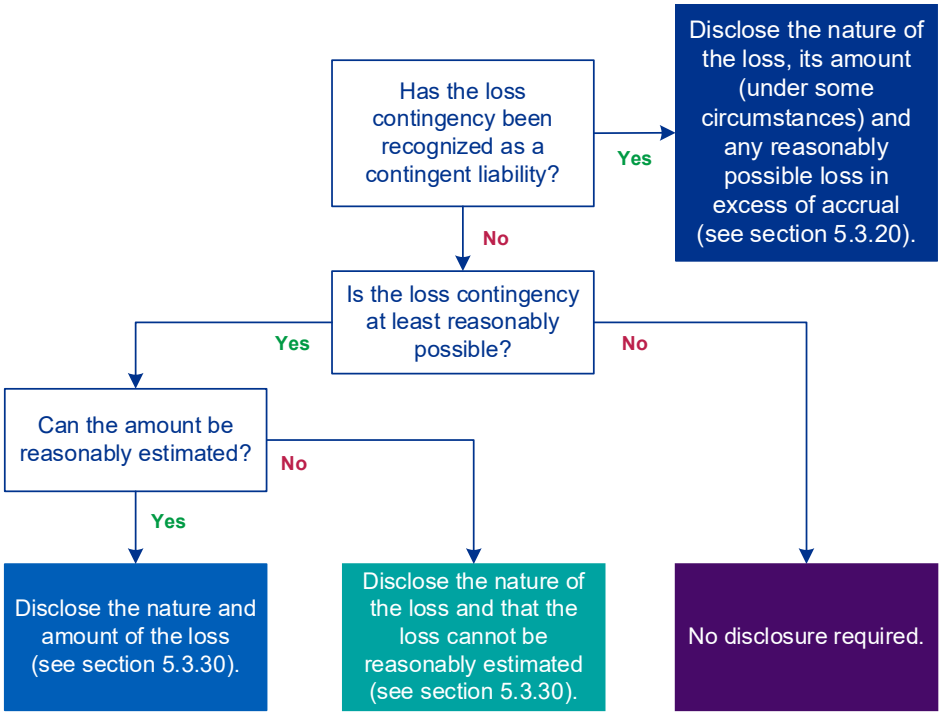
The following table summarizes the presentation requirements for loss contingencies in each financial statement.

Financial statement	Account/Activity	Presentation requirement
Balance sheet	Contingent liability	• Generally classified as current or noncurrent based on the expected period of settlement. • Not presented net of a related recovery asset except in the rare case that the right of setoff conditions in paragraph 210-20-45-1 are met (see Question 6.5.20).
Income statement	Accrual expense or release	• Classified in operating activities when the loss contingency relates to ongoing operations. • Reported in discontinued operations when the loss contingency relates to those operations. • Presented separately when the loss contingency is unusual or infrequent under Subtopic 220-20. • May be presented net of any related recovery income (see section 6.5.20).
Statement of cash flows	Cash settlement	• Classified as cash flows for operating activities (see section 5.2.30).

Disclosure

The disclosure objective of Topic 450 is to provide financial statement users with sufficient information to understand the nature and, when applicable, the amount of the contingent liability. The following decision tree summarizes the disclosure requirements.

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Gain contingencies and loss recoveries

Gain contingencies and loss recoveries are accounted for under two different accounting models, but sometimes both models are applied to the same transaction (see discussion of the mixed model below).

Loss recovery model

Recoveries of costs and losses incurred are accounted for under the loss recovery model when there is direct linkage to the loss event. The model typically applies to insured losses – e.g. those related to involuntary conversions, workers' compensation claims and environmental matters.

Under the loss recovery model, a recovery is recognized when it is probable and reasonably estimable. The amount of the recovery recognized is capped at the amount of the costs and losses incurred (i.e. recognized). Probable means likely to occur, as defined in Subtopic 450-20 regarding loss contingencies.

Gain contingency model

A gain contingency is an existing condition, situation or set of circumstances involving uncertainty as to possible gain that will ultimately be resolved when one or more future events occur or fail to occur.

A gain contingency is not recognized before its realization. Realization requires resolution of all uncertainties and is typically when cash or a claim to cash is received.

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Unlike for loss contingencies and loss recoveries, probability is not a factor in the recognition of gain contingencies. Therefore, gain contingencies are typically recognized later than loss contingencies and loss recoveries, even when they relate to the same loss event.

Mixed model

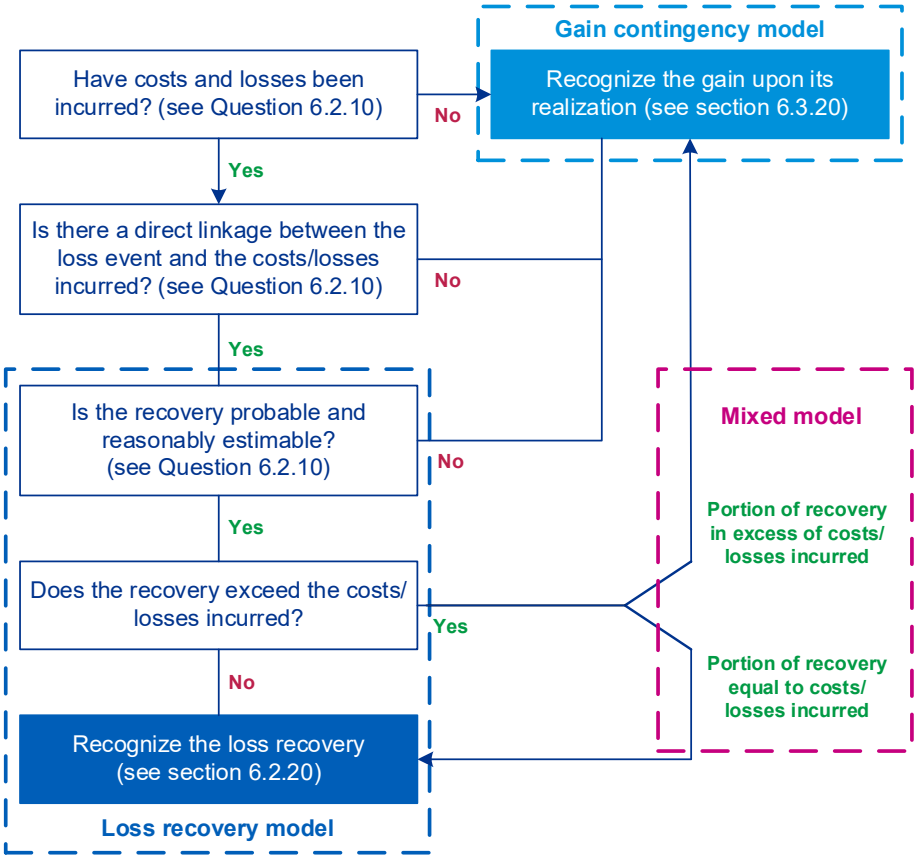
Some transactions involving the recovery of losses are bifurcated, with:

- the loss recovery model applying to the anticipated recovery of costs and losses incurred (with a direct linkage to the loss event); and
- the gain contingency model applying to any remaining amount of the anticipated recovery.

The mixed model often applies to recoveries from business interruption insurance.

Summary

The following diagram summarizes the decision points involved in accounting for a loss recovery and gain contingency.



Read more: chapter 6

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Guarantees and product warranties

Topic 460 establishes accounting and disclosure requirements for the guarantor (obligor) of guarantees, including product warranties. It provides separate scoping, recognition and measurement guidance for product warranties as compared to other guarantees. Some of its disclosure requirements apply to both product warranties and guarantees, and others incrementally apply to product warranties (see section 7.7).

References to 'guarantees' in this Handbook are to guarantees other than product warranties, and separate discussion is provided for these guarantees (see sections 7.2 through 7.5) and product warranties (see section 7.6).

Guarantees

Some guarantees in Topic 460's scope are subject to all of its guidance while others are subject only to its disclosure guidance.

Guarantee contracts in Topic 460's scope	
• Financial guarantees • Performance guarantees	• Indemnifications • Indirect guarantees of indebtedness of others
Guarantee contracts excluded from Topic 460's entire scope	
• Guarantees or indemnifications that are excluded from Topic 450's scope, such as employment-related guarantees • Guarantees or indemnifications in the scope of certain other Topics/Subtopics	• Guarantees or indemnifications whose existence prevents sale accounting • Guarantees or indemnifications of an entity's own future performance
Guarantee contracts excluded from Topic 460's general recognition and measurement (but not disclosure) guidance	
• Certain guarantees issued between entities under common control	• Guarantees in the scope of certain other Topics/Subtopics

A guarantor is required to recognize a liability for both the noncontingent and contingent components of guarantees. How each component is measured and how those measurements interact depends on whether the guarantee is also in the scope of either Subtopic 326-20 or Topic 480 and, if not, on the guarantor's accounting policy election.

Product warranties

Product warranties are guarantees for which the underlying is related to the performance (regarding function, not price) of nonfinancial assets that are owned by the guaranteed party. The obligation may be incurred in connection with the sale of goods or services and, if so, it may require further performance by the seller after the sale has taken place.

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Measurement of the guarantee obligation for a product warranty depends on whether it is a service-type (Topics 605 and 606 apply) or an assurance-type warranty (Subtopic 450-20 applies, with incremental guidance provided in Topic 460).

Read more: chapter 7

Commitments

Topic 440 establishes required disclosures for:

- certain commitments; and
- certain unconditional purchase obligations.

Certain commitments

Topic 440 requires the following types of items to be disclosed in the financial statements:

- unused letters of credit;
- leases;
- assets pledged as security for loans;
- pension plans;
- the existence of cumulative preferred stock dividends in arrears; and
- commitments, including:
  - a commitment for plant acquisition;
  - an obligation to reduce debts;
  - an obligation to maintain working capital; and
  - an obligation to restrict dividends.

Topic 440 does not contain specific disclosure requirements for these items – although other Topics may. Instead, it simply states they are to be disclosed in the financial statements.

Unconditional purchase obligations

Although an unconditional purchase obligation is a type of commitment, it is subject to specific disclosures under Topic 440. It is defined as "an obligation to transfer funds in the future for fixed or minimum amounts or quantities of goods or services at fixed or minimum prices."

Unless an unconditional purchase obligation qualifies for a specific scope exclusion, it is subject to Topic 440's disclosures when it has all of the following characteristics.

- It is cancelable only under certain conditions.
- It was negotiated as part of arranging financing for facilities that will provide contracted goods or services or for costs related to those goods or services (e.g. carrying costs for contracted goods).
- It has a remaining term in excess of one year.

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Topic 440 contains different disclosure requirements for recognized versus unrecognized unconditional purchase obligations.

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2. Contingencies: Key concepts and scope

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2.1 How the standard works

Subtopic 450-10 establishes the scope for both Subtopic 450-20 (loss contingencies) and Subtopic 450-30 (gain contingencies). Topic 450 applies to all entities.

Loss or gain contingencies

A contingency contains the following three elements.



For a contingency to exist, there must be an existing condition involving uncertainty as to a possible loss or gain that will be resolved when one or more future events occur or fail to occur. The accounting for contingencies often involves estimates; however, measurements of assets and liabilities may require estimates for reasons other than contingencies. For example, if there is nothing uncertain about a liability having been incurred (e.g. services have been received), accrual is required even if the amount and/or timing of settlement are not yet known.

Scope of Topic 450

Topic 450 applies only to contingencies – but not all contingencies are within its scope. When a contingent loss or gain exists, it is not accounted for under Topic 450 if it falls in the scope of another Topic (e.g. asset retirement obligations under Topic 410). There is a long list of contingent losses and gains that are in the scope of other Topics (see Question 2.3.10). Some of these other Topics apply the contingency models in Topic 450 in whole or part.

There are also many instances in which a transaction produces multiple contingencies – some in the scope of Topic 450 and some in the scope of other Topics. For example, natural disasters can create multiple contingencies.

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2.2 Key concepts

Excerpt from ASC 450-10

20 Glossary

Contingency

An existing condition, situation, or set of circumstances involving uncertainty as to possible gain (**gain contingency**) or loss (**loss contingency**) to an entity that will ultimately be resolved when one or more future events occur or fail to occur.

Loss Contingency

An 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. 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.

General

05-6 Not all uncertainties inherent in the accounting process give rise to **contingencies**. Estimates are required in financial statements for many ongoing and recurring activities of an entity. The mere fact that an estimate is involved does not of itself constitute the type of uncertainty referred to in the definition of a loss contingency or a gain contingency. Several examples of situations that are not contingencies are included in Section 450-10-55.

> Overall Guidance

15-1 The Scope Section of the Overall Subtopic establishes the pervasive scope for all Subtopics of the Contingencies Topic. Unless explicitly addressed within specific Subtopics, the following scope guidance applies to all Subtopics of the Contingencies Topic.

> Entities

15-2 The guidance in the Contingencies Topic applies to all entities.

> Other Considerations

15-3 In some cases, there may be uncertainty about whether a situation is a **contingency**. Section 450-10-55 includes several situations that are not contingencies, and thus are outside the scope of the Contingencies Topic.

> Implementation Guidance

55-1 This Section includes several situations that do not meet the definition of a **contingency**, and thus are outside the scope of this Topic.

• > Depreciation

55-2 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 utility of the asset is not uncertain. Thus, depreciation of assets is not a contingency, nor are such

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matters as recurring repairs, maintenance, and overhauls, which interrelate with depreciation. This Topic is not intended to alter present depreciation practices as described in Section 360-10-35.

• > Estimates Used in Accruals

55-3 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.

• > Changes in Tax Law

55-4 The possibility of a change in the tax law in some future year is not an uncertainty.

Excerpt from ASC 450-20

> Accruals of Loss Contingencies Do Not Provide Financial Protection

05-8 Accrual of a loss related to a **contingency** does not create or set aside funds to lessen the possible financial impact of a loss. 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.

05-9 An 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 accounting standards set forth in this Subtopic do not affect the fundamental business economics of that decision. That is a financial decision, and if an entity's management decides to do neither, 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.

Subtopic 450-10 establishes the scope for both Subtopic 450-20 (loss contingencies) and Subtopic 450-30 (gain contingencies). [450-10-15-1]

Topic 450 applies only when an existing condition creates a contingency. If there is no uncertainty, Topic 450 does not apply. [450-10-15-3]

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Question 2.2.10 What is a contingency?

Interpretive response: A contingency is an existing condition, situation or set of circumstances involving uncertainty that can result in a possible gain or loss for the entity, depending on future events. [450-10 Glossary]



These three elements can be demonstrated in the context of a loss contingency through a simple example. If several customers are injured on an entity's premises (e.g. due to an infrastructure failure), the entity likely will be subject to personal injury claims. The event causing the injuries is the existing condition. Uncertainty exists as to the extent of the customers' injuries and the nature and amount of the damages they will seek (e.g. reimbursement of medical expenses, compensation for pain and suffering). Only future events will enable the entity to determine the loss it has incurred (e.g. the assertion of claims by customers, settlement negotiations, potential litigation).

Topic 450 gives some examples of noncontingencies.

- **Depreciation.** Although estimates are used to allocate the cost of a depreciable asset over the period of use by an entity, the eventual expiration of the asset's utility is not uncertain. [450-10-55-2]
- **Services received.** Amounts owed for services received 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. [450-10-55-3]
- **Change in tax laws.** The possibility that tax laws will change in the future is not an uncertainty. [450-10-55-4]

Question 2.2.20 What are contingent liabilities?

Interpretive response: The Codification does not use the term contingent liabilities and FASB Concepts Statement No. 8, Conceptual Framework for Financial Reporting (CON 8), has acknowledged that this term has been a source of confusion. In practice, this term is sometimes used interchangeably with the term loss contingencies. [CON 8.E60]

This Handbook uses 'contingent liability' to describe the liability that results from recognizing a loss contingency in the scope of Topic 450. [450-10-05-2, 05-4]

Question 2.2.30 What is the difference between contingent liabilities and incurred liabilities?

Interpretive response: As explained in Question 2.2.10, Topic 450 does not apply to situations where there is nothing uncertain about an obligation having been incurred – i.e. incurred liabilities. [450-10-55-3]

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In some situations, determining whether a liability has been incurred may require judgment. Laws, regulations and contracts (either written or oral) can give rise to incurred liabilities or loss contingencies, depending on the circumstances. Loss contingencies may arise, for example, when there is uncertainty as to the rights and obligations under a contract (or even the existence of a contract), or as to whether and how a regulation applies to an entity's activities.

When there is nothing uncertain about the fact that an obligation has been incurred, the liability is recognized, even if its amount or timing is not currently known and its measurement requires estimation. Subtopic 410-20 is very clear about this concept in the context of asset retirement obligations. It provides that "[i]f a current law, regulation, or contract requires an entity to perform an asset retirement activity when an asset is dismantled or demolished, there is an unambiguous requirement to perform the retirement activity…. Therefore, the obligation to perform the asset retirement activity is unconditional even though uncertainty exists about the timing and (or) method of settlement." [410-20-25-13]

An entity applies a Topic or Subtopic other than Subtopic 450-20 to an obligation subject to uncertainty when the obligation is within the scope of that other Topic or Subtopic. Otherwise, Subtopic 450-20 is applied.

Example 2.2.10 Structured settlement

To settle a lawsuit, ABC Corp agrees to pay Injured Individual $500,000 a year over the next 10 years. This arrangement is known as a structured settlement because it is an agreement by one party to pay another party a fixed stream of payments over a specified time.

ABC does not apply Subtopic 450-20 to the structured settlement because there is no underlying contingency – i.e. there is no question an obligation exists. Instead, there is an obligation ABC accounts for as an incurred liability under Subtopic 835-30 (imputation of interest) because it is a contractual obligation to pay money on fixed or determinable dates. Therefore, it initially measures the liability at the fair value of the future stream of payments and accretes any resulting discount as interest expense over the life of the arrangement using the interest method. [835-30-15-2, 25-10, 35-2]

Question 2.2.40 What is the difference between contingent liabilities, accruals and accrued payables?

Interpretive response: 'Accruing' generally refers to the accounting mechanism used to recognize a liability (or an asset) by allocating costs (or income) among accounting periods. Loss contingencies may need to be 'accrued', i.e. recognized, once they meet the recognition criteria in Subtopic 450-20. Upon accrual, these loss contingencies become contingent liabilities (see Question 2.2.20), but not all accruals represent contingent liabilities. [450-20-05-09]

Accrued payables generally refer to liabilities for amounts due but unbilled as of a certain date. Often, absent an invoice, amounts owed for services received

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have to be estimated, but such estimation does not give rise to contingencies because nothing is uncertain about those obligations having been incurred. Therefore, accrued payables are not contingent liabilities (see Question 2.2.30). [450-10-55-3]

Question 2.2.50 What is the difference between contingent liabilities and reserves?

Interpretive response: Contingent liabilities are a type of accounting accrual (sometimes referred to as accounting reserves) but are different than the act of 'reserving' or setting aside specific assets to be used for a particular purpose. The existence of a liability on the balance sheet does not mean that an entity has set aside specific assets to be used to settle a loss contingency or has sufficient liquid funds to do so. Accounting accruals have no effect on an entity's cash flows. The decision to maintain sufficient liquid assets or purchase insurance is a financial decision and the use of accounting accruals to recognize loss contingencies does not reduce or eliminate risk. [450-20-05-8, 05-9, 25-8]

Subtopic 450-20 prohibits using the term reserve to describe an accounting accrual for a loss contingency. That term is limited to an amount of unidentified or unsegregated assets held or retained for a specific purpose. [450-20-50-1]

Question 2.2.60 What is the difference between contingencies and commitments?

Interpretive response: Commitments are not automatically contingencies; however, they may require disclosure and some may create loss contingencies. Topic 440 addresses commitments and discusses both general commitments and unconditional purchase obligations. See chapter 8 for detailed discussion about commitments.

2.3 Loss contingencies in scope of Subtopic 450-20

Excerpt from ASC 450-10

> Transactions

15-2A The guidance in the Contingencies Topic does not apply to the recognition and initial measurement of assets or liabilities arising from contingencies that are measured at fair value or assets arising from contingencies measured at an amount other than fair value on the **acquisition date** in a business combination under the requirements of Subtopic 805-20, on the acquisition date in an **acquisition by a not-for-profit entity** under the requirements of Subtopic 958-805, or on the **formation date** in a **joint venture** formation under the requirements of Subtopic 805-60. Those Subtopics provide the recognition and initial measurement requirements for

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assets and liabilities arising from contingencies measured at fair value and for assets arising from contingencies measured at an amount other than fair value as part of a business combination, an acquisition by a not-for-profit entity, or a joint venture formation.

Excerpt from ASC 450-20

05-3 The following are examples of loss contingencies for which links are provided in Section 450-20-60:

a. Collectibility of receivables
b. Obligations related to product warranties and product defects
c. Risk of loss from catastrophes assumed by property and casualty insurance entities including **reinsurance** entities
d. Guarantees of indebtedness of others
e. Obligations of commercial banks under standby letters of credit
f. Agreements to repurchase receivables (or to repurchase the related property) that have been sold.

> Types of Loss Contingencies

05-10 The following are examples of loss contingencies that are discussed in this Subtopic:

a. Injury or damage caused by products sold
b. Risk of loss or damage of property by fire, explosion, or other hazards
c. Actual or possible claims and assessments
d. Threat of expropriation of assets
e. Pending or threatened litigation

> Overall Guidance

15-1 This Subtopic follows the same Scope and Scope Exceptions as outlined in the Overall Subtopic, see Section 450-10-15, with specific transaction exceptions noted below.

> Transactions

15-2 The following transactions are excluded from the scope of this Subtopic because they are addressed elsewhere in the Codification:

a. Stock issued to employees, which is discussed in Topic 718.
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.
c. Uncertainty in income taxes, which is discussed in Section 740-10-25.
d. Accounting and reporting by insurance entities, which is discussed in Topic 944.
e. Measurement of credit losses for instruments within the scope of Topic 326 on measurement of credit losses.

If a loss contingency exists (see section 2.2), evaluating whether the contingency is in the scope of Topic 450 is necessary. Gain contingencies are discussed in chapter 6.

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There are numerous sources of uncertainties that may affect the financial statements. However, Topic 450 is not a 'one-stop shop' in the Codification that addresses all types of contingencies. Instead, some contingencies are directly addressed in other Topics, and Topic 450 applies to those contingencies that are otherwise not addressed directly in another Topic.

There are two important nuances to this dichotomy.

- In complex situations, there may be multiple types of contingencies to consider, specific aspects of which could be within the scope of several Topics, including Topic 450 (e.g. natural disasters, business restructuring).
- Even when a Topic other than Topic 450 directly applies to a contingency, the other Topic may refer to Topic 450 for certain matters, like recognition, measurement and/or disclosure. Sometimes those other Topics provide explanatory guidance on how to apply Subtopic 450-20's loss contingency model and other times they do not.

Some of these situations are discussed in section 2.4.

Question 2.3.10 What loss contingencies are in the scope of Topics other than Subtopic 450-20?

Interpretive response: A loss contingency could involve:

- expenses, such as litigation settlements or damages paid to third parties for defects in the entity's products; and/or
- losses incurred related to an entity's assets, such as impairments to assets or expropriations of assets (see Question 2.3.20).

Subtopic 450-20 applies to loss contingencies that are not otherwise scoped into another Topic or Subtopic. The following table lists common situations that could result in contingencies in the scope of Topics or Subtopics other than Subtopic 450-20. While presented in the context of loss contingencies, many of these situations could produce either loss or gain contingencies.

Contingency arising from:	Applicable guidance	Source
Risks and uncertainties related to the entity's operations	Topic 275	450-20-60-1
Firm purchase commitments for inventory	Topic 330	450-20-60-5
Insurance and reinsurance contracts that do not transfer insurance risk	Topic 340	450-10-60-2
Insurance-related assessments, including insurance activities of an entity that self-insures	Topic 405	450-20-60-6
Asset retirement and environmental obligations	Topic 410	450-20-60-7 – 60-8
Product warranties	Topic 460 (see section 7.6)	450-20-55-2, 60-9

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Contingency arising from:	Applicable guidance	Source
Guarantees	Topic 460 (see sections 7.3 and 7.5.30)	450-20-50-5, 60-10
Contingent payments in troubled debt restructurings	Subtopic 470-60	450-20-60-12
Variable consideration in revenue contracts	Topic 606	450-10-60-3
Variable consideration in contracts to transfer nonfinancial assets and in-substance nonfinancial assets to noncustomers	Subtopic 610-20	450-10-60-4
Employment-related costs, including deferred compensation contracts	Topics 710, 712 and 715	450-20-15-2
Contingencies related to withdrawal from multiemployer plans	Topic 715	450-20-60-13
Stock issued to employees	Topic 718	450-20-15-2
Contingencies associated with a multiple-year retrospectively rated insurance contract accounted for as insurance	Topic 720	450-10-60-5
Contingencies related to an insurance contract or reinsurance contract	Topic 720	450-20-60-14
Income tax uncertainties	Topic 740	450-10-60-6 450-20-15-2
Assets or liabilities measured at fair value, and assets measured at an amount other than fair value, related to a business combination, acquisition of a not-for-profit entity or formation of a joint venture recognized and measured at the acquisition/formation date.	Topic 805 or 958 (for not-for-profit entities)	450-10-15-2A
Contractual termination benefits and curtailment losses under benefit plans triggered by business combinations	Topic 805	450-10-60-7
Financial instruments issued as contingent consideration in business combinations and accounted for as derivatives	Topic 815	815-40-15-2(a)
Variable lease payments	Topic 842	450-10-60-8 450-20-60-15 450-30-60-5
Lease indemnifications for environmental contamination	Topic 842	450-20-60-16
Contingencies related to agreements to repurchase receivables	Topic 860	450-20-60-17

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Contingency arising from:	Applicable guidance	Source
Contingencies related to the Coal Industry Retiree Health Benefit Act of 1992 for extractive activities in the mining industry	Topic 930	450-20-60-18
Certain insurance contracts issued by insurance or reinsurance entities	Topic 944	450-10-60-9 – 60-11 450-20-15-2, 60-19
Contingencies related to the collectibility of interest receivable by investment companies	Topic 946	450-20-60-20
Malpractice claims against health care entities	Topic 954	450-20-60-21

Question 2.3.20 How do the asset impairment guidance and Topic 450 relate to each other?

Interpretive response: While Subtopic 450-20 addresses loss contingencies incurred related to an entity's assets, such as asset impairments, it only applies to such loss contingencies in the absence of other applicable guidance.

There are several Topics that address impairment of particular types of assets – e.g. impairment of inventory (Topic 330), goodwill and indefinite-lived intangible assets (Topic 350), property, plant and equipment and finite-lived intangible assets (Topic 360) and certain financial instruments (see below). Topic 450 does not apply to impairments in the scope of these and other Topics.

Subtopic 450-20 applies its loss contingency model to asset impairments in its scope by stating that losses from impairment are accrued if it is probable that an asset has been impaired at the date of an entity's financial statements. Losses that relate to a future period are not accrued at that date. [450-20-25-2]

Credit impairment of financial assets (credit losses)

Topic 326 (financial instruments – credit losses) provides guidance for recognizing credit losses on instruments in its scope. With some exceptions, Topic 326 applies to financial assets measured at amortized cost, net investments in leases, off-balance sheet credit exposures not accounted for as insurance, reinsurance recoverables and available-for-sale debt securities. Therefore, credit losses for those instruments are outside the scope of Subtopic 450-20.

However, there are certain financial instruments that are outside the scope of Topic 326 and, therefore, are subject to Subtopic 450-20 for impairment purposes unless another Topic applies.

Chapter 2 and section 19.2 of KPMG Handbook, Credit impairment, provide guidance on what financial instruments are in the scopes of Subtopic 326-20 and Subtopic 326-30, respectively.

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Question 2.3.30 Are tax contingencies in the scope of Topic 450?

Interpretive response: It depends on whether the contingency relates to *income* taxes or *non-income-based* taxes. Topic 740 provides guidance on accounting for uncertainty in income taxes, while Topic 450 applies to contingencies associated with non-income-based taxes.

Income taxes

Under Topic 740, an entity recognizes in its financial statements the benefit of an uncertain income tax position only if it is more likely than not that the position will be sustained (based on its technical merits) upon examination by tax authorities (see section 3 of KPMG Handbook, Accounting for income taxes).

Non-income-based taxes

For guidance on the application of Topic 450 to uncertainty in non-income-based taxes, see section 3.7.40.

2.4 Scoping issues for certain events and transactions

2.4.10 Natural disasters

Several types of contingencies can arise from natural disasters (e.g. floods, hurricanes, tornadoes).

Question 2.4.10 How does Topic 450 apply to natural disasters?

Interpretive response: Natural disasters may cause damage or destroy an entity's assets, such as property and equipment. When nonmonetary assets are involuntarily converted to monetary assets (such as insurance proceeds), Subtopic 610-30 applies. However, Subtopic 610-30 does not directly address the timing for recognition of the loss and recovery when a nonmonetary asset is damaged or destroyed in one accounting period (loss) but the insurance proceeds to be received are not determinable until a subsequent accounting period (recovery). Subtopic 610-30 requires Topic 450 to be applied to recognize the loss (see chapter 3) and recovery (see section 6.2). [610-30-25-1 – 25-4]

Other contingent events related to natural disasters

An entity's alleged actions during or after a natural disaster can give rise to litigation (or threatened litigation). The natural disaster can also cause environmental damage requiring remediation or contract breaches and early

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terminations. Such situations are contingencies and are evaluated to determine if they are in the scope of Subtopic 450-20.

For example, legal claims are expected to be in the scope of Subtopic 450-20. In contrast, an anticipated environmental remediation liability arising from a natural disaster is in the scope of Subtopic 410-30 (see section 9.2 of KPMG Handbook, Climate risk in the financial statements).

2.4.20 Employee benefits

Excerpt from ASC 712-10

> Determining the Timing and Method of Accruing Other Postemployment Benefits

25-4 Other postemployment benefits that meet the conditions in paragraph 710-10-25-1 shall be accounted for in accordance with Subtopic 710-10.

25-5 Other postemployment benefits that are within the scope of this Subtopic and that do not meet the conditions in paragraph 710-10-25-1 shall be accounted for in accordance with paragraph 450-20-25-2. For example, an employer may provide any former employee on permanent disability with continued medical insurance coverage until that employee meets the requirements for participation in the employer's postretirement medical plan. If the level of benefits provided is the same for any disabled employee regardless of years of service, the cost of those benefits should be recognized when the event causing a permanent disability occurs and a reasonable estimate can be made as specified by that paragraph.

Employee benefits can consist of many elements – from base wages and salaries to deferred compensation arrangements, share-based payment arrangements and postretirement and postemployment benefits. The accounting treatment depends on the type of arrangement. An entity applies Topic 450 only when:

- there is no other specified accounting treatment in Topics 710 (compensation), 712 (nonretirement postemployment benefits), 715 (retirement benefits) or 718 (stock compensation); or
- one of the aforementioned Topics requires application of Topic 450.

Question 2.4.20 Does Topic 450 apply to nonretirement other postemployment benefits?

Background: Nonretirement other postemployment benefits are postemployment benefits that are not 'special' or contractual termination benefits.

Interpretive response: Yes, but only in the circumstances specified in Topic 712 as noted in the following table.

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Nonretirement other postemployment benefits that…	Accounting treatment
vest or accumulate (and meet other conditions in paragraph 710-10-25-1)	Use Subtopic 710-10's compensated absences recognition model [712-10-25-4]
do not vest or accumulate (or do not meet the other conditions in paragraph 710-10-25-1)	Use Subtopic 450-20's loss contingency model (paragraph 450-20-25-2) [712-10-25-5]

For additional information about accounting for nonretirement other postemployment benefits, see section 4.6 of KPMG Handbook, Employee benefits. [710-10-25-1, 450-20-25-2]

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3. Loss contingencies: Recognition

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Example 3.7.20 Liability for sales and use tax

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3.8 Derecognition

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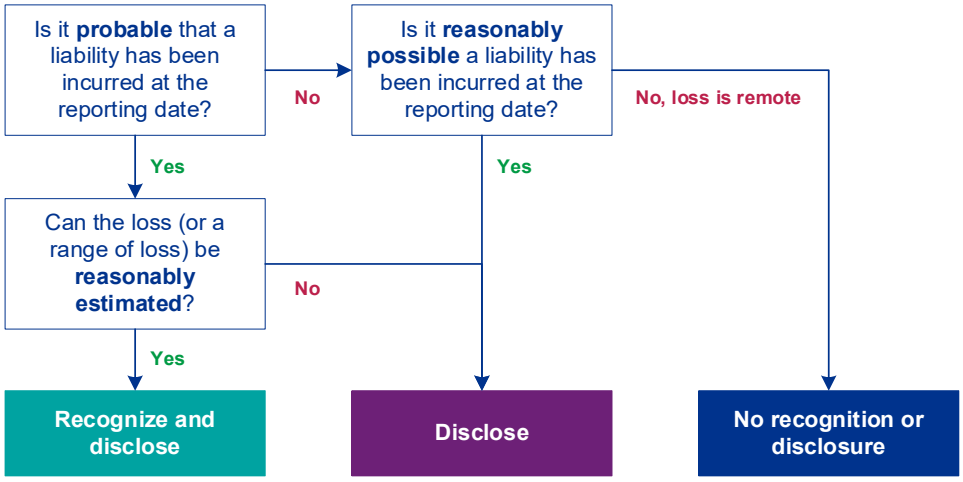
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3.1 How the standard works

There are three potential financial reporting outcomes for a loss contingency in the scope of Subtopic 450-20:

- recognize a loss and disclose;
- do not recognize a loss, but disclose; or
- do not recognize a loss or disclose.

The following decision tree explains which outcome is appropriate in a given situation.



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3.2 Loss contingencies recognition criteria

Excerpt from ASC 450-20

> General Rule

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.

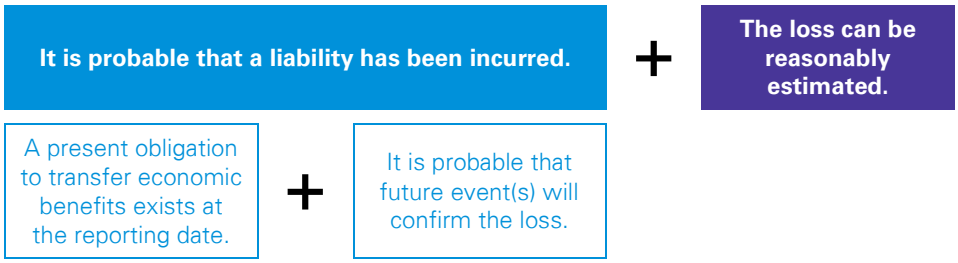
• > Business Risks

25-8 General or unspecified business risks do not meet the conditions for accrual in paragraph 450-20-25-2, and no accrual for loss shall be made.

A loss contingency can occur due to either a probable impairment of an asset or a probable incurrence of a liability. Most of this chapter directly addresses the probable incurrence of a liability because, in many cases, asset impairments are in the scope of Topics other than Subtopic 450-20 (see Question 2.3.20). However, section 3.7.30 explains how Subtopic 450-20 applies to the impairment of an asset due to expropriation.

A loss contingency in the scope of Subtopic 450-20 is recognized as a contingent liability when the following two criteria are met at the reporting date.

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Assessing these criteria considers all information available before the financial statements are issued or available to be issued. This means that subsequent events may affect whether it is probable a liability had been incurred at the reporting date. See section 3.6 for more information on subsequent events. [450-20-25-2]

3.3 Determining whether it is probable a liability has been incurred

The first recognition criterion is it is probable that a liability has been incurred. [450-20-25-2(a)]

CON 8 defines a liability as "a present obligation of an entity to transfer an economic benefit", meaning it has the following two essential characteristics: [CON 8.E37 – E38]

- it is a present obligation (see section 3.3.10); and
- it requires an entity to transfer or otherwise provide economic benefits to others (see section 3.3.20).

It is important to note that CON 8 does not speak to when a liability must be recognized. Rather, it provides the two essential characteristics that any liability, including a contingent liability, must satisfy at a minimum. Subtopic 450-20 builds on this definition to provide the criteria a loss contingency must meet to be recognized as a contingent liability.

Probability concepts are discussed in section 3.3.30.

3.3.10 Present obligation and obligating event

Question 3.3.10 What is a present obligation?

Interpretive response: The first essential characteristic of a liability is that there is a present obligation at the reporting date. Obligations recognized as liabilities require the entity to act a certain way because they: [CON 8.E41 – E53]

- stem from either:
  - — contracts or agreements that are enforceable at law, including legal construction of a contract under the doctrine of promissory estoppel; or

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  - constructive obligations (e.g. past behaviors) that bound the entity to act a certain way; and
- involve society or other parties whose identity may be unknown before settlement.

Further, there must be an event or an underlying cause for legal action that occurs to trigger an obligation. For example, a negligent act that causes harm to a third party can trigger an obligation to that third party under a state law. We refer to triggering events as 'obligating events' (see below and Question 3.3.20).

Obligating event must create a present obligation

For there to be a *present* obligation at the reporting date, the obligating event must occur on or before the reporting date. No present obligation exists even if it is virtually certain at that date that an obligating event will occur in the future when at present no such event has actually occurred. [CON 8.E47]

Therefore, loss contingencies are not recognized before the obligating (underlying loss) event has occurred. A loss contingency is not recognized even if, based on past experience or other factors, it is probable that an obligating event will occur in the future. The existence of a risk of future loss does not support current recognition of the expected loss except where required by other US GAAP (e.g. premium deficiencies for insurance entities in Subtopic 944-60).

Uncertainty around a present obligation

The term contingent liability has been a source of confusion because it is often thought to refer to circumstances in which the existence of an obligation depends on the occurrence or nonoccurrence of a future event. Absent a present obligation, the occurrence or nonoccurrence of a future event does not by itself give rise to a liability in the present. Contingent liabilities satisfy the definition of a liability because the contingency does not relate to whether a present obligation exists, but instead relates to one or more uncertain future events that will affect the amount required to settle the present obligation. For those obligations, the fact that the outcome of those future events is unknown affects the measurement – but not the existence – of the liability. [CON 8.E60]

Continuing with the example involving a negligent act as the obligating event, the entity responsible for that act may not know by its reporting date whether, and to what extent, the third party was actually harmed or whether they will even submit a claim. Ultimately, the entity could be obligated to pay the third party based on this act, but there is uncertainty as to whether it will be held liable and for how much. Therefore, the entity assesses if the loss is probable (see section 3.3.30) and a reasonable estimate can be made (see section 3.4) to determine whether to recognize a contingent liability related to the present obligation.

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Question 3.3.20 What are examples of obligating events?

Interpretive response: The obligating event is the event that triggers an obligation of the entity at the point in time the event occurs. [CON 8.E47]

Examples of obligating events include:

- breaching contracts;
- engaging in an activity that creates a statutory liability (e.g. paying wages to employees creates an employment tax liability);
- violating a statute (or possibly a rule or regulation) (e.g. violating the Clean Air Act can lead to fines imposed by the Act); and
- engaging in activity that harms others (e.g. causing physical harm to third parties as a result of negligent actions by employees can make an entity liable for damages to those third parties).

Entering into transactions can also create obligating events, such as the consummation of a business combination or the successful completion of an initial public offering. Enactment of legislation by a governmental authority can also constitute an obligating event.

The date an obligating event occurs is the date the entity's obligation is triggered. If the obligating event occurs before the reporting date, the obligation is triggered as of that date even if the related claims are only made known or filed after that date (i.e. unasserted claims). This is because, in litigation, the underlying incident is the obligating event rather than the assertion or filing of the claim. See section 3.5.20 for additional discussion of unasserted claims. [720-20-25-14]

3.3.20 Transfer of economic benefits

Question 3.3.30 What are economic benefits?

Interpretive response: The second essential characteristic of a liability is that the obligation requires an entity to transfer or provide economic benefits to others or to be ready to do so. Therefore, the transfer of economic benefits is the means of settling an obligation. [CON 8.E54]

Settlement is not always in cash. Instead, the obligation may require the entity to provide economic benefits in one or more of the following ways: [CON 8.E54 – E56]

- convey other assets;
- grant a right to use an asset;
- provide (or stand ready to provide) services;
- replace the obligation with another obligation;
- convert the obligation to equity;
- transfer shares of the entity;

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- refrain from engaging in certain types of activities (e.g. a noncompete agreement); or
- forgo an economic benefit to which the entity is otherwise entitled.

This list is not all-inclusive and an entity could be obligated to transfer, or stand ready to transfer, other types of economic benefits.

Question 3.3.40 Can a loss contingency be probable if the nature, amount or timing of the economic benefits to be transferred is unknown?

Interpretive response: Yes. As is common with contingent liabilities, the nature of the economic benefits to be transferred may be unknown at the reporting date. For example, the entity may be able or be required to settle an obligation by remitting cash or other assets subject to an uncertain future event. In addition, while the amount and value of the economic benefits required to settle the obligation and the timing of their transfer may also be unknown or subject to an uncertain future event, the underlying obligating event has already occurred. Therefore, in these cases, the uncertain outcome of the future event may affect how the liability is measured, but not the existence of the liability.

3.3.30 Likelihood of the loss

Excerpt from ASC 450-20

20 Glossary

Probable

The future event or events are likely to occur.

Reasonably Possible

The chance of the future event or events occurring is more than remote but less than likely.

Remote

The chance of the future event or events occurring is slight.

> General Rule

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.

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> Assessing Probability of Incurrence of a Loss

25-3 The conditions in the preceding paragraph are not intended to be so rigid that they require virtual certainty before a loss is accrued. Instead, the condition in (a) in the preceding paragraph is intended to proscribe accrual of losses that relate to future periods.

If a loss in connection with a contingency is probable (i.e. if it is probable that future event(s) will confirm that a liability has been incurred), then a contingent liability is recognized if it is reasonably estimable.

If a loss is not probable in connection with a contingency, no contingent liability is recognized. If the loss is reasonably possible (but not probable), then only disclosure is required (see chapter 5).

If a loss in connection with a contingency is remote, then an entity does not recognize a contingent liability or disclose the loss contingency under Topic 450.

Topic 450 defines both probable, reasonably possible and remote in general terms and does not assign specific quantitative thresholds to those terms. [450-20 Glossary]

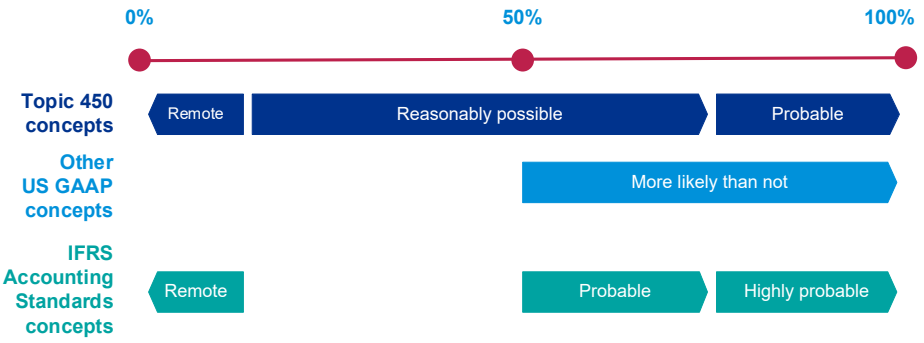
Question 3.3.50 What do 'probable', 'reasonably possible' and 'remote' mean?

Interpretive response: 'Probable' under US GAAP means likely to occur. While not quantitatively defined in the Codification, the concept is interpreted to mean that there is a high likelihood that the future event will occur. [450-20 Glossary]

The term 'probable' may be a source of confusion because the word is used under IFRS Accounting Standards with a different meaning – that is, more likely than not. Therefore, probable under US GAAP is a higher threshold than probable under IFRS Accounting Standards. The meaning of probable under US GAAP generally translates to 'highly probable' under IFRS Accounting Standards. [IAS 37, IFRS 15]

The following diagram depicts the interplay between 'probable' and other terms commonly used to describe different levels of likelihood in Topic 450 and other US GAAP and under IFRS Accounting Standards. The percentages shown in the diagram are not to scale and should not be used to infer the percentage of likelihood behind the respective terms. Nevertheless, in practice, we believe that the term 'remote' is used to indicate a likelihood of 10% or less.

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3.4 Determining whether the loss can be reasonably estimated

Excerpt from ASC 450-20

> Assessing Whether a Loss Is Reasonably Estimable

25-4 The condition in paragraph 450-20-25-2(b) is intended to prevent accrual in the financial statements of amounts so uncertain as to impair the integrity of those statements.

25-5 That requirement shall not delay accrual of a loss until only a single amount can be reasonably estimated. To the contrary, when the condition in paragraph 450-20-25-2(a) is met and information available indicates that the estimated amount of loss is within a range of amounts, it follows that some amount of loss has occurred and can be reasonably estimated. Thus, when the condition in paragraph 450-20-25-2(a) is met with respect to a particular loss contingency and the reasonable estimate of the loss is a range, the condition in paragraph 450-20-25-2(b) is met and an amount shall be accrued for the loss.

The second recognition criterion for a loss contingency is that the amount of loss can be reasonably estimated. [450-20-25-2(b)]

This criterion is not intended to delay accrual of a loss when there is some estimation uncertainty. Instead, it is intended to prevent accruing of amounts so uncertain as to impair the integrity of the financial statements. Further, Subtopic 450-20 states that disclosure is *preferable* to accrual when a reasonable estimate of loss cannot be made. See section 5.3 for these disclosure requirements. [450-20-25-4 – 25-5]

Question 3.4.10 How does an entity determine whether a loss contingency can be reasonably estimated?

Interpretive response: Determining whether a loss can be reasonably estimated may require significant judgment. However, in our experience, it is rare that a probable loss contingency is not accrued because it cannot be

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reasonably estimated. One reason for this is that the ability to estimate a range of loss (rather than a single amount) can satisfy the reasonably estimable criterion. In that situation, the entity applies the measurement principles in Subtopic 450-20 to determine the amount of loss within the range to accrue (see Question 4.3.10). Further, if the loss remains probable over several periods, we would not expect an entity to continue to assert that a reasonable estimate of a loss cannot be made. [450-20-25-5]

An entity is expected to undertake a thorough process that attempts to estimate the possible loss or range of loss. A reasonable estimate is usually developed from the specific facts and circumstances relevant to the contingency. It also takes into account the entity's experience with similar uncertainties and, in some situations, the entity's evaluation of the current economic environment. An evaluation of the current economic environment includes existing industry, geographical, economic and political factors that are relevant to the uncertainty.

Nevertheless, we believe an entity's lack of experience in assessing the amount of a loss contingency does not necessarily preclude the entity from developing an estimate. Also relevant is the experience of other entities with similar uncertainties in similar businesses, which may inform the entity's estimation process.

Each situation will have its own obstacles to contend with. For example, an entity's reasonable estimates of IBNR asbestos liabilities may be difficult due to factors such as:

- the volatility of asbestos-related litigation against the entity or other entities;
- the inherent uncertainty in the volume and nature of future asserted claims; and
- any changes in laws and regulations under which claims are currently filed.

These factors do not preclude the entity from estimating a loss when information needed to develop a reasonable estimate is available. An entity may use its own historical claims data or other relevant and reliable information from other entities to estimate the loss. These points are highlighted in a 2020 order issued by the SEC's Division of Enforcement against a registrant for failing to account for certain asbestos liabilities.

3.5 Litigation, claims and assessments

3.5.10 Overview

Excerpt from ASC 450-20

> Implementation Guidance

• > Litigation, Claims, and Assessments

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55-10 The following factors should be considered in determining whether accrual and/or disclosure is required with respect to pending or threatened litigation and actual or possible claims and assessments:

a. The period in which the underlying cause (that is, the cause for action) of the pending or threatened litigation or of the actual or possible claim or assessment occurred
b. The degree of probability of an unfavorable outcome
c. The ability to make a reasonable estimate of the amount of loss.

Examples 1 through 2 (see paragraphs 450-20-55-18 through 55-35) illustrate the consideration of these factors in determining whether to accrue or disclose litigation.

• • > Losses Arising Before the Date of the Financial Statements

• • • > Assessing Probability of the Incurrence of a Loss

55-12 If the underlying cause of the litigation, claim, or assessment is an event occurring before the date of an entity's financial statements, the probability of an outcome unfavorable to the entity must be assessed to determine whether the condition in paragraph 450-20-25-2(a) is met. Among the factors that should be considered are the following:

a. The nature of the litigation, claim, or assessment
b. The progress of the case (including progress after the date of the financial statements but before those statements are issued or are available to be issued [as discussed in Section 855-10-25])
c. The opinions or views of legal counsel and other advisers, although, 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
d. The experience of the entity in similar cases
e. The experience of other entities
f. Any decision of the entity's management as to how the entity intends to respond to the lawsuit, claim, or assessment (for example, a decision to contest the case vigorously or a decision to seek an out-of-court settlement).

55-13 The filing of a suit or formal assertion of a claim or assessment does not automatically indicate that accrual of a loss may be appropriate. The degree of probability of an unfavorable outcome must be assessed. The condition in paragraph 450-20-25-2(a) would be met if an unfavorable outcome is determined to be probable. Accrual would be inappropriate, but disclosure would be required, if an unfavorable outcome is determined to be **reasonably possible** but not probable, or if the amount of loss cannot be reasonably estimated.

55-14 With respect to unasserted claims and assessments, an entity must determine the degree of probability that a suit may be filed or a claim or assessment may be asserted and the possibility of an unfavorable outcome. If an unfavorable outcome is probable and the amount of loss can be reasonably estimated, accrual of a loss is required by paragraph 450-20-25-2. For example:

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a. A catastrophe, accident, or other similar physical occurrence predictably engenders claims for redress, and in such circumstances their assertion may be probable.
b. An investigation of an entity by a governmental agency, if enforcement proceedings have been or are likely to be instituted, is often followed by private claims for redress, and the probability of their assertion and the possibility of loss should be considered in each case.
c. An entity may believe there is a possibility that it has infringed on another entity's patent rights, but the entity owning the patent rights has not indicated an intention to take any action and has not even indicated an awareness of the possible infringement. In that case, a judgment must first be made as to whether the assertion of a claim is probable.

55-15 If the judgment is that assertion is not probable, no accrual or disclosure would be required. On the other hand, if the judgment is that assertion is probable, then a second judgment must be made as to the degree of probability of an unfavorable outcome. The disclosures described in paragraphs 450-20-50-3 through 50-8 would be required in either of the following circumstances:

a. An unfavorable outcome is probable but the amount of loss cannot be reasonably estimated.
b. An unfavorable outcome is reasonably possible but not probable.

• • • > Assessing Whether a Loss Is Reasonably Estimable

55-16 As a condition for accrual of a loss contingency, the condition in paragraph 450-20-25-2(b) requires that the amount of loss can be reasonably estimated. In some cases, it may be determined that a loss was incurred because an unfavorable outcome of the litigation, claim, or assessment is probable (thus satisfying the condition in paragraph 450-20-25-2[a]), but the range of possible loss is wide. Examples 1 and 3 (see paragraphs 450-20-55-18 and 450-20-55-36) illustrate the application of the standards in this Subtopic when the range of possible loss is wide.

Subtopic 450-20 specifically addresses loss contingencies related to litigation, claims and assessments. The following factors are relevant in determining whether accrual and/or disclosure is required for pending or threatened litigation and asserted or unasserted claims and assessments: [450-20-55-10 – 55-15, 55-27 – 55-30]

- the period in which the underlying cause of action (i.e. the obligating event) occurred (see section 3.3.10);
- the degree of probability of an unfavorable outcome (see section 3.3.30); and
- the ability to make a reasonable estimate of the amount of loss (see section 3.4).

Additionally, when evaluating litigation, claims and disputes related to a customer, an assessment should be made to determine whether they are within the scope of Subtopic 450-20 or Topic 606 (see Question 2.2.35 in KPMG Handbook, Revenue recognition).

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3.5.20 Loss contingencies related to unasserted claims

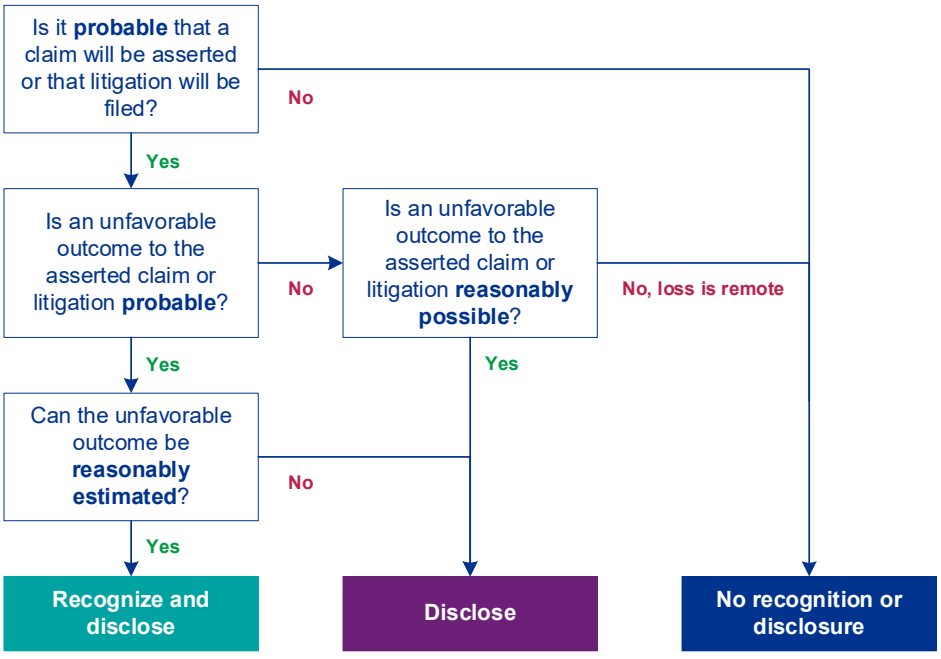
Question 3.5.10 What is an unasserted claim?

Interpretive response: An unasserted claim exists when an obligating event has occurred but the claim has not yet been asserted (i.e. declared) at the reporting date. This may be because the claimant either is unaware of the event or its right to file a claim or has not yet taken legal action. IBNR claims (a term commonly used in accounting for insurance contracts) are a type of unasserted claim (see Question 3.7.40). [720-20-25-14]

For example, if in-house counsel investigates internal practices and identifies instances of discrimination that likely would lead to lawsuits, those instances can constitute an obligating event even though a lawsuit has not been formalized. Next, the entity needs to determine whether it is probable that there will be an unfavorable outcome as explained in Question 3.5.20. [450-20-55-10, 55-11]

Question 3.5.20 How is an unasserted claim accounted for?

Interpretive response: Determining if and when the loss contingency arising from an unasserted claim needs to be recognized requires judgment. The steps are depicted in the following decision tree. [450-20-55-14 – 55-15]



See section 5.3 for disclosure requirements.

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Question 3.5.30 What is the unit of account for a claim?

Interpretive response: Depending on the nature of the contingency, we believe the Subtopic 450-20 recognition criteria may be considered in relation to individual claims or in relation to groups of similar types of claims. Examples of the latter include workers' compensation claims or class action lawsuits. If the criteria are met, the loss contingency is accrued even though specific claimants may not yet be identifiable.

Question 4.3.30 describes measurement of the contingent liability in situations where there is a large population of similar claims.

3.5.30 Loss contingencies related to litigation

Question 3.5.40 How is probability assessed when evaluating the recognition of a contingent liability for litigation?

Interpretive response: There are several factors to consider in assessing the probability that a liability has been incurred when the entity is the defendant in litigation – whether that liability occurs through an eventual settlement or through an adverse ruling (i.e. opinion, judgment, finding) by the court. [450-20-55-12]

Assessing whether settlement is probable

Typically, an entity facing a lawsuit determines whether it should try to settle the litigation. A conclusion by the entity that settlement is probable means it is probable that the entity has incurred a liability. [450-20-55-36]

A conclusion about the probability of settlement often occurs after the parties have discussed settlement and conducted some level of discovery, but it could occur after only one – or neither – of these events if, for example, the entity has a history of making settlement offers in similar situations. Further, settlement can become probable at any point during the litigation process – before, during or after trial.

Subtopic 450-20's Example 3 (see section 3.5.40) illustrates how to assess the likelihood of settling litigation. In that example, the entity (a defendant in litigation) concludes that settlement is probable based on:

- information obtained through discovery;
- the costs and risks of litigation to both parties; and
- the plaintiff's offer to settle, which indicates an express willingness to settle for some amount.

Typically, the likelihood of settlement depends on the legal merits of the case, which is discussed below under 'Assessing whether an adverse court ruling is probable'. Both parties assess the case's legal merits, as well as anticipated litigation costs, in determining whether to make a settlement offer and for how much.

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The conclusion that it is probable a case will settle instead of being tried prompts the entity to reasonably estimate the range of loss. In Subtopic 450-20's Example 3, the high end of the range of loss is the plaintiff's settlement offer. The low end is based on the entity's assessment of the minimum amount the case could settle for based on the underlying assumption that settlement is probable. In other words, the low end of the range when settlement is probable is not zero because this outcome is only possible in a court ruling. See Question 4.3.40 for further discussion of this example, including how the loss contingency is measured.

Assessing whether an adverse court ruling is probable

If an entity determines that settlement is not probable, it next assesses the likelihood of the court ruling it liable. We believe determining the likelihood of an adverse court ruling requires assessing the legal merits of the entity's case vis-à-vis the legal merits of the plaintiff's case. This may require considering the statutes at issue, any legislative history behind those statutes, any applicable government regulations and relevant case law – all in the context of the facts that are probable of being proven during litigation.

An entity's prior history with similar cases can also be relevant, as can other entities' histories with similar cases. However, such histories are to be evaluated in light of a well-reasoned assessment of the legal merits of the current case.

Although legal counsel can be instrumental in assessing whether an adverse court ruling is probable, it is management's responsibility to determine whether the probability threshold has been met.

Further, legal counsel's inability to express an opinion that the outcome will be favorable to the entity does not necessarily mean that the probability threshold is met and a contingent liability is accrued. [450-20-55-12(c)]

Assessing the appellate process

Part of assessing whether an adverse ruling by the court is probable involves considering what might happen should the entity or other party appeal the trial court's judgment. In assessing the merits of an entity's case (as described above), legal counsel considers case law in the appropriate appellate jurisdiction.

Question 3.5.50 How does a trial court ruling affect the probability analysis?

Interpretive response: It depends on whether the ruling is favorable or unfavorable. Once the trial court enters a ruling (which essentially makes its opinion official), the parties have a window during which to appeal the ruling. The litigation is over if this window expires without either party appealing, but during this window, the entity still applies the loss contingency model to determine whether to:

- continue to recognize a contingent liability and, if so, for what amount; or
- recognize a previously unrecognized loss contingency.

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This determination is also required during the appellate process if the decision is appealed.

Unfavorable ruling

Prior to receiving an adverse court ruling, an entity may have determined that the likelihood of it being held liable by the court was less than probable. Receipt of an adverse court ruling is obviously strong evidence that the probability threshold to accrue a loss contingency has been met.

However, we believe all facts and circumstances need to be considered and the adverse court ruling may not be the only relevant evidence considered. The entity may still evaluate its arguments on appeal, taking into account the case law in the appellate jurisdiction, the trial record and any potential errors in applying the law the trial court may have made.

If the entity does not intend to appeal the adverse court ruling, then a liability has been incurred. We believe this is true even if the entity intends to appeal the amount of damages awarded to the plaintiff. Such an appeal is relevant in measuring the amount of the liability but not in recognizing the liability.

Favorable ruling

Conversely, a trial court ruling absolving the entity from any liability is strong evidence that a liability is not probable. However, we believe all facts and circumstances need to be considered in this situation, especially if the plaintiff is likely to appeal. For example, legal counsel may opine that there is a substantial risk that an appellate court will overrule the trial court, in which case the entity factors that opinion into its updated probability analysis.

Further, even if legal counsel does not believe it is probable that the appellate court will overrule the trial court, the entity might still make a settlement offer to avoid the appellate litigation (or be willing to accept a settlement offer by the plaintiff). In that case, the entity performs the settlement offer analysis described in Question 4.3.40.

3.5.40 FASB examples

Excerpt from ASC 450-20

> Illustrations

• > 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.

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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

• • > 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.

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• • > 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 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.

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3.6 Evaluating subsequent events

Excerpt from ASC 450-20

> Events After the Date of the Financial Statements

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.

25-7 If a loss cannot be accrued in the period when it is probable that an asset had been impaired or a liability had 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.

> Implementation Guidance

• > Litigation, Claims, and Assessments

• • > Losses Arising Before the Date of the Financial Statements

55-11 Accrual may be appropriate for litigation, claims, or assessments whose underlying cause is an event occurring on or before the date of an entity's financial statements even if the entity does not become aware of the existence or possibility of the lawsuit, claim, or assessment until after the date of the financial statements. If those financial statements have not been issued or are not yet available to be issued (as discussed in Section 855-10-25), accrual of a loss related to the litigation, claim, or assessment would be required if the probability of loss is such that the condition in paragraph 450-20-25-2(a) is met and the amount of loss can be reasonably estimated.

• • > Losses Arising after the Date of the Financial Statements

55-17 As a condition for accrual of a loss contingency, the condition in paragraph 450-20-25-2(a) requires that information available before the financial statements are issued or are available to be issued (as discussed in Section 855-10-25) indicate that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. Accordingly, accrual would clearly be inappropriate for litigation, claims, or assessments

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whose underlying cause is an event or condition occurring after the date of financial statements but before those financial statements are issued or are available to be issued. For example, an entity would not accrue a suit for damages alleged to have been suffered as a result of an accident that occurred after the date of the financial statements. However, disclosure may be required by paragraphs 450-20-50-9 through 50-10.

Subsequent events are events or transactions that occur after the reporting date (i.e. balance sheet date) but before the financial statements are issued or are available to be issued (i.e. the subsequent events period). Subsequent events are categorized into two broad types with the following effects on the financial statements. [855-20 Glossary]

Recognized events (Type 1)	Nonrecognized events (Type 2)
Events or transactions that provide additional evidence about conditions that existed at the reporting date.	Events that provide evidence about conditions *that did not exist* at the reporting date but arose subsequent to that date.
Financial statement effects at the reporting date	
Adjustments are made for Type 1 subsequent events. [855-10-25-1]	Adjustments are not made for Type 2 subsequent events; instead, disclosure is necessary if the financial statements would otherwise be misleading. [855-10-50-2, Rules 10b-5, 12b-20]

See chapter 9 in KPMG Handbook, Financial statement presentation.

Question 3.6.10 How are subsequent events assessed in the context of loss contingencies?

Interpretive response: When assessing whether a liability has been incurred or an asset has been impaired at the reporting date, all information available before the financial statements are issued or available to be issued needs to be considered. For example, information obtained during the subsequent events period is considered when determining whether a present obligation existed at the reporting date. Topic 855 specifically addresses how litigation settlements in the subsequent events period affect the measurement of the loss estimate. [450-20-25-2, 25-6, 855-10-55-1(a)]

The assessment of subsequent events related to loss contingencies requires judgment to determine if they are Type 1 or Type 2 events. This assessment may vary depending on the specific circumstances of each event.

Event	Type	Example
Subsequent events affecting recognition either…		
…confirm that it was probable a liability had been incurred at the reporting date; or [450-20-25-6]	1	A claim received from an employee during the subsequent events period for a work-related injury that occurred before the reporting date confirms that a present obligation existed at the reporting date and it

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Event	Type	Example
		was probable a liability had been incurred.
…create a new obligation after the reporting date. [450-20-25-6, 855-10-55-2(c)]	2	An employee's work-related injury during the subsequent events period creates a new obligation for the employer. Such subsequent event may need to be disclosed at the reporting date.
Subsequent events affecting measurement…		
…provide additional evidence relevant to the measurement of the loss estimate. [855-10-55-1(a)]	1	The settlement, after the reporting date, of litigation existing at the reporting date for an amount different from that accrued is considered in the estimate of the loss at the reporting date.

See Question 9.4.80 in KPMG Handbook, Financial statement presentation, for additional information about the events and examples in this table.

3.7 Other recognition considerations

3.7.10 Products sold

Excerpt from ASC 450-20

> Implementation Guidance

• > Injury or Damage Caused by Products Sold

55-2 If it is **probable** that a claim resulting from injury or damage caused by a product defect will arise with respect to products or services that have been sold, accrual for losses may be appropriate. The condition in paragraph 450-20-25-2(a) would be met, for instance, with respect to a drug product or toys that have been sold if a health or safety hazard related to those products is discovered and as a result it is considered probable that liabilities have been incurred. The condition in paragraph 450-20-25-2(b) would be met if experience or other information enables the entity to make a reasonable estimate of the loss with respect to the drug product or the toys.

Subtopic 450-20 specifically addresses loss contingencies related to injury or damage caused by products sold. [450-20-55-2]

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Question 3.7.10 When is the liability recognized for injury or damage caused by products sold?

Interpretive response: A loss contingency may need to be accrued for injury or damage caused by products sold as soon as the product defect causing the health or safety hazard is uncovered. This can be before a claim is filed.

Once a defect is uncovered, an entity performs a probability analysis to determine the likelihood that a liability for injuries or other damages has been incurred as a result of the defect. The entity also assesses whether the loss can be reasonably estimated (see section 3.4). We believe the amount of loss can be reasonably estimated if experience or other information enables the entity to reasonably estimate the loss with respect to the product.

The estimate of the loss that is assessed for reasonableness includes costs associated with remediating expected future incidents arising from defective products sold at or before the reporting date.

3.7.20 Insured and self-insured risks

Excerpt from ASC 450-20

> Implementation Guidance

• > Risk of Loss or Damage of Property

55-3 At the date of an entity's financial statements, it may not be insured against risk of future loss or damage to its property by fire, explosion, or other hazards. Some risks, for all practical purposes, may be noninsurable, and the self-assumption of those risks is mandatory.

55-4 The absence of insurance against losses from risks of those types constitutes an existing condition involving uncertainty about the amount and timing of any losses that may occur, in which case a **loss contingency** exists. Uninsured risks may arise in a number of ways, including the following:

a. Noninsurance of certain risks
b. Co-insurance or deductible clauses in an insurance contract
c. Insurance through a subsidiary or investee to the extent not reinsured with an independent insurer. (The effects of transactions between a parent or other investor and a subsidiary or investee insurance entity should be eliminated from an entity's financial statements in accordance with paragraphs 810-10-45-1 and 323-10-35-7.)

55-5 The absence of insurance does not mean that an asset has been impaired or a liability has been incurred at the date of an entity's financial statements. Fires, explosions, and other similar events that may cause loss or damage of an entity's property are random in their occurrence. With respect to events of that type, the condition in paragraph 450-20-25-2(a) is not satisfied prior to the occurrence of the event because until that time there is no diminution in the value of the property. There is no relationship of those events to the activities of the entity prior to their occurrence, and no asset is impaired prior to their

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occurrence. Further, unlike an insurance entity, which has a contractual obligation under policies in force to reimburse insureds for losses, an entity can have no such obligation to itself and, hence, no liability.

• > Risk of Loss from Future Events

55-6 An entity may choose not to purchase insurance against risk of loss that may result from injury to others, damage to the property of others, or interruption of its business operations. Exposure to risks of those types constitutes an existing condition involving uncertainty about the amount and timing of any losses that may occur, in which case a **contingency** exists.

55-7 Mere exposure to risks of those types, however, does not mean that an asset has been impaired or a liability has been incurred. The condition in paragraph 450-20-25-2(a) is not met with respect to loss that may result from injury to others, damage to the property of others, or business interruption that may occur after the date of an entity's financial statements. Losses of those types do not relate to the current or a prior period but rather to the future period in which they occur. Thus, for 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.

55-8 On the other hand, the conditions in paragraph 450-20-25-2 would be met with respect to uninsured losses resulting from injury to others or damage to the property of others if both of the following are true:

a. The event took place prior to the date of the financial statements, even though the entity may not become aware of those matters until after that date.
b. The experience of the entity or other information enables it to make a reasonable estimate of the loss that was incurred prior to the date of its financial statements.

Injury or damage resulting from products that have been sold are discussed in paragraph 450-20-55-2.

• > Net Loss on Insurance Policies

55-17A This Subtopic does not prohibit (and, in fact, requires) accrual of a net loss (that is, a loss in excess of deferred premiums) that probably will be incurred on insurance policies that are in force, provided that the loss can be reasonably estimated.

Entities often enter into insurance arrangements to mitigate their exposure to various loss contingencies. The fact that an entity may be uninsured, underinsured or self-insured against certain risks economically exposes it to an increased risk of loss. However, the lack of insurance or sufficient insurance – i.e. self-insurance – does not by itself create a loss contingency to be recognized (see Question 3.7.20).

Further, loss contingencies can also relate to events for which the entity is insured (see Question 3.7.30).

For guidance on how an insurance entity within the scope of Topic 944 accounts for a reinsurance transaction – i.e. entering into a reinsurance contract

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with another insurance entity to mitigate its exposure on a contract or group of contracts – see Topic 944.

Question 3.7.20 When is a liability for self-insured risks recognized?

Background: Entities in all industries routinely face exposure to loss contingencies associated with a variety of risks for which they may choose not to obtain third-party insurance coverage. Such risks are commonly referred to as uninsured risks, underinsured (i.e. retained) risks or self-insured risks. Typical risks may include exposure related to workers' compensation (including second injury funds), general liability, product liability, automobile liability, professional liability, and medical and disability risks. There are many forms of self-insurance, including high deductibles, limited coverage, or no coverage for a particular risk.

Interpretive response: The recognition of a liability for self-insured risks is governed by the criteria in Subtopic 450-20. Therefore, an entity accrues a loss for claims and incidents that are self-insured when it is probable that a liability has been incurred and the amount of the loss is reasonably estimable. If those criteria are not met, it is not appropriate for a self-insured entity to accrue a liability for the uninsured loss. The lack of insurance for coverage of common risks does not by itself result in the accrual of a loss contingency. [450-20-25-2(a)]

Example 3.7.10 Uninsured damage from risk of severe weather

An agribusiness has no insurance to cover wind damage. The lack of insurance coverage does not meet the criteria in Subtopic 450-20 to recognize a loss for future crop damage. It would only be appropriate to recognize the loss at the reporting date if the wind damage has actually occurred as of that date and the amount of the loss can be reasonably estimated. Even if the agribusiness has had repeated damage to its crops from wind storms in prior reporting periods, it is not appropriate for it to recognize a loss related to future crop damage based on a history of wind storms.

Question 3.7.30 Is a loss contingency accrued when the risk is insured?

Interpretive response: Generally, yes. We generally believe that an entity accrues loss contingencies related to an insured risk when the recognition criteria in Subtopic 450-20 are met, without considering the possible effect of insurance. This is because the existence of an insurance arrangement to cover losses typically does not result in the entity being legally released as the primary obligor – i.e. insured claims are obligations of the insured entity who then turns to the insurer for reimbursement under the insurance policy. This may be the case even if the insurer processes claims on behalf of the insured entity. Insurance policies that transfer the primary obligation to the insurer

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generally require claimant consent. Understanding whether consent has been obtained and the obligation transferred to the insurer is a matter of legal interpretation.

For example, an entity may have workers' compensation insurance to protect itself against employees' claims for work-related injuries. When the insurance does not legally relieve the entity from being the primary obligor to the employees, the loss contingency and the potential insurance recovery are assessed separately for recognition and measurement.

Under the general framework of Subtopic 450-20, an entity accrues a loss for insured risks when it is probable that a liability has been incurred and the amount of the loss is reasonably estimable. Any amount recovered from its insurer is accounted for as a separate transaction (see chapter 6).

Question 3.7.40 When is a liability for IBNR claims, including claims covered by a 'claims-made' insurance contract, recognized?

Excerpt from ASC 720-20

Claims-Made Contracts

> Recognizing a Liability for Incurred but Not Reported Claims

25-14 Paragraph 450-20-25-2 requires that insured entities (except as discussed in Section 944-20-15), including those that use a claims-made approach for insuring certain risks, recognize a liability for the probable losses from incurred but not reported claims and incidents if the loss is both probable and reasonably estimable. Paragraphs 450-20-55-10 through 55-17 provide implementation guidance about litigation, claims, and assessments.

Background: A 'claims-made' insurance contract is one that insures an entity for claims made (asserted) during the policy period even if the loss event occurred outside of the policy period. However, the entity is not insured for claims made after the policy period terminates, even if the loss event occurred during the policy period. [720-20-05-4]

An IBNR claim relates to losses incurred by the insured entity that have not yet been reported to the insurance entity. [720-20 Glossary]

Interpretive response: Subtopic 720-20 indicates that a liability for IBNR claims, including those insured under a claims-made policy, is accrued under paragraph 450-20-25-2. Because an IBNR claim is an unasserted claim, it is analyzed using the steps explained in Question 3.5.20. [720-20-25-14]

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3.7.30 Threat of expropriation

Excerpt from ASC 450-20

> Implementation Guidance

• > Threat of Expropriation

55-9 The threat of expropriation of assets is a contingency (as defined) because of the uncertainty about its outcome and effect. The condition in paragraph 450-20-25-2(a) is met if both of the following are true:

a. Expropriation is imminent.
b. Compensation will be less than the carrying amount of the assets.

Imminence 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. The condition in paragraph 450-20-25-2(b) requires that accrual be made only if the amount of loss can be reasonably estimated. If the conditions for accrual are not met, the disclosures described in paragraphs 450-20-50-3 through 50-8 would be made if there is at least a reasonable possibility that an asset has been impaired.

A loss contingency can arise when it is probable that either a liability has been incurred or an asset has been impaired. The threat of expropriation more directly relates to the impairment of assets to be expropriated. [450-20-25-2(a)]

Question 3.7.50 When is an asset impaired under the threat of expropriation guidance?

Interpretive response: Subtopic 450-20 specifically addresses loss contingencies related to threats of expropriation. This 'asset expropriation guidance' states that an expropriation loss contingency is probable if (a) expropriation is imminent (i.e. about to happen) and (b) the compensation will be less than the carrying amount of the assets to be expropriated. [450-20-55-9]

Expropriation may be considered imminent by: [450-20-55-9]

- public or private declarations by the applicable governmental entity; or
- actual expropriation of assets of other entities.

When an entity determines that compensation will be less than the carrying amount of the assets to be expropriated, it accrues the loss contingency (by impairing the related assets) if it can reasonably estimate the loss. [450-20-55-9]

When the conditions for recognizing an impairment are not met, but there is at least a reasonable possibility that an asset has been impaired, an entity is required to 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. [450-20-50-3 – 50-8, 55-9]

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Question 3.7.60 How do the asset impairment guidance and the asset expropriation guidance relate to each other?

Interpretive response: For assets subject to potential expropriation, both of the following apply:

- the asset expropriation guidance in Subtopic 450-20; and
- the relevant impairment guidance for the type of asset (e.g. Topic 360 for long-lived assets).

The primary consideration in determining the effects of applying this guidance is whether expropriation is imminent.

Impairment loss before expropriation is imminent

An expropriation loss contingency is not recognized until expropriation is 'imminent'. By contrast, the business, legal or other factors that may lead to expropriation, or other factors entirely, may trigger an impairment of the asset under the relevant impairment guidance for the asset type before expropriation becomes imminent.

For example, the adverse legal or business factors that may ultimately lead to expropriation (which is not yet imminent) may:

- constitute an impairment triggering event for a long-lived asset (or for the asset group to which the asset belongs) under Topic 360; or
- cause the entity to conclude the possibility of expropriation makes it 'more likely than not' (i.e. a greater than 50% likelihood) the asset will be disposed of significantly before the end of its previously estimated useful life.

In either case, an impairment assessment under Topic 360 would be required before expropriation is imminent. [360-10-35-21]

Additional loss once expropriation becomes imminent

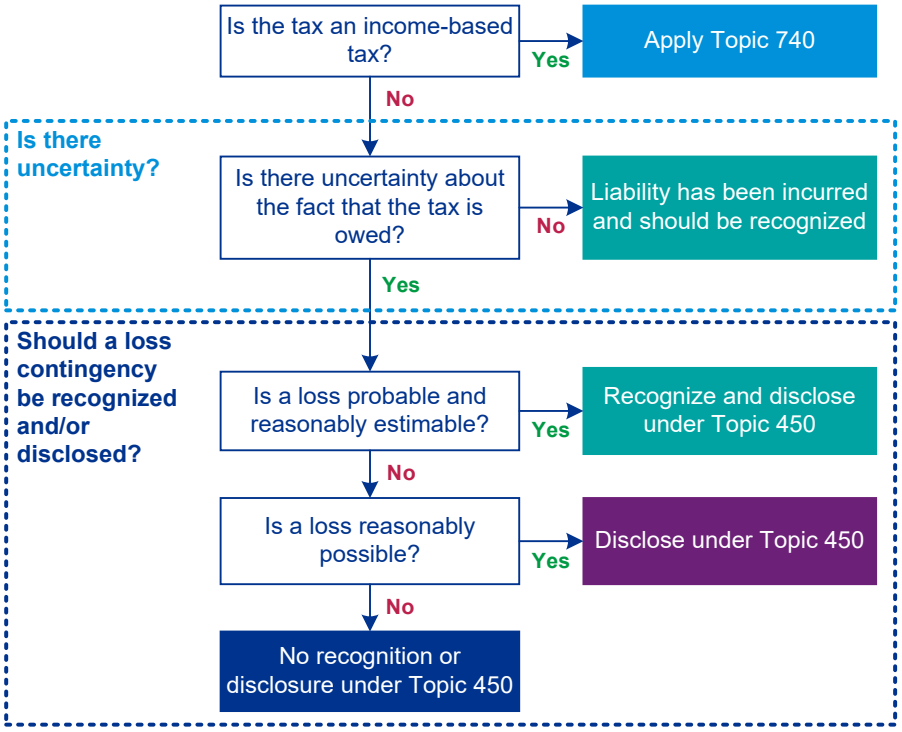
Even if an impairment assessment is triggered by the potential of expropriation that is not yet imminent, no impairment loss may result from following the applicable impairment guidance (e.g. the asset group to which the expropriated asset belongs is not impaired when assessed under Topic 360). Alternatively, even if an impairment charge is taken on the asset, such charge may not represent full impairment of the asset under the relevant guidance. In either case, an additional loss may need to be recognized and/or disclosed under the asset expropriation guidance once expropriation becomes imminent and the conditions in paragraph 450-20-55-9 are met.

KPMG Handbook, Impairment of nonfinancial assets, explains when and how long-lived assets are tested for impairment.

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3.7.40 Non-income-based taxes

Whether and how Topic 450 applies to non-income-based taxes depends on whether there is uncertainty related to the entity having an obligation to pay the tax. The following decision tree summarizes the effects of uncertainty on the accounting for the tax obligation.



Question 3.7.70 How does an entity determine whether there is uncertainty about the tax being owed?

Interpretive response: Determining whether a non-income-based tax liability has been incurred (i.e. tax is owed) can be unclear. In these cases, we believe an entity considers the legal basis for its position not to pay the tax to evaluate 'existence' uncertainty – i.e. evaluate if there is uncertainty about whether the tax obligation exists and, if so, Topic 450 applies.

One approach to determining whether there is existence uncertainty is to look at the guidance on evaluating income tax uncertainties – i.e. is it more likely than not that the entity's position not to pay the tax would be upheld by the taxing authority.

- If the answer is No (i.e. it is not more likely than not), conclude a liability has been incurred and determine whether specific recognition guidance applies – e.g. Subtopic 720-30 for real and personal property taxes.
- If the answer is Yes (i.e. it is more likely than not), treat it as a contingency and assess whether to accrue the loss under Subtopic 450-20.

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When assessing the likelihood of the position being upheld, an entity evaluates the legal basis assuming the taxing authority has access to all relevant information – i.e. the entity does not consider detection risk.

Question 3.7.80 How does Topic 450 apply to uncertainty in non-income-based taxes?

Interpretive response: If there is uncertainty about the tax being owed, then a loss contingency in the scope of Subtopic 450-20 exists. An entity accrues a loss contingency only if it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated. Disclosure is required if there is a reasonable possibility that a loss may have been incurred. [450-20-25-2]

To assess the probability of a non-income tax liability for an unasserted claim for which there is uncertainty about whether the tax is owed, the entity considers the likelihood that (a) the claim will be asserted by the taxing authority (i.e. the entity considers detection risk) and (b) there will be an unfavorable outcome (see Question 3.5.20). [450-20-55-14]

Change in estimate after the reporting date

Question 9.4.80 and Example 9.4.60 in KPMG Handbook, Financial statement presentation, address the requirements of Topic 855 (subsequent events) relative to contingencies. They illustrate the requirements using a change in the expected settlement for unpaid sales and use taxes.

Abatement, refund or credit of non-income-based taxes

For guidance on the accounting for an abatement, refund or credit of a non-income-based tax, see Questions 6.2.80 and 6.2.90.

Example 3.7.20 Liability for sales and use tax

ABC Corp, a Northeast retailer operating in 10 states, has sold goods in New York for two years without reporting or paying sales and use tax. Although ABC acknowledges its liability if audited, it considers the chance of an audit to be low.

Topic 450's guidance on detection risk for unasserted claims applies only to contingencies. Here, ABC's liability is certain – i.e. there is no existence uncertainty. Therefore, ABC concludes that the failure to collect and remit sales and use taxes is not an unasserted claim under Topic 450. ABC makes its best estimate of the obligation assuming the taxing authority has access to all relevant information.

Example 3.7.30 Liability for unemployment claims

Under state law, ABC Corp may choose one of the following methods to pay unemployment insurance contributions:

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- pay a percentage of gross wages; or
- reimburse the state employment commission directly for actual unemployment claims.

ABC chooses to reimburse the state for the actual claims that arise. ABC has no claims filed against it in the current reporting period.

Because there is no uncertainty whether the unemployment insurance contributions are owed, a liability is incurred in each period as employees work to earn the benefit. Therefore, ABC accrues its estimated unemployment insurance costs in the current reporting period even though no claims were filed against it in the current period. The accrual is based on its estimated or past history of unemployment insurance costs. [TQA 3100.01]

3.8 Derecognition

Subtopic 450-20 does not specifically address derecognition of a contingent liability.

Question 3.8.10 When is a contingent liability derecognized?

Interpretive response: A contingent liability is derecognized when either:

- the underlying obligation is extinguished (i.e. settled); or
- the recognition criteria for a loss contingency are no longer met – i.e. the loss is no longer probable or reasonably estimable. [450-20-25-2]

For example, if an entity records a contingent liability based on pending litigation, the liability is derecognized upon the entity either:

- settling the litigation; or
- determining it is no longer probable that a loss will be incurred due to developments in the litigation (note that this determination is judgmental and requires careful consideration of the evidence to support the entity's conclusion).

The derecognition of a contingent liability could result in additional disclosures as follows.

- If there is still a reasonable possibility that a liability has been incurred at the reporting date, specific disclosures are required (see section 5.3.30 for the disclosure requirements for unrecognized loss contingencies).
- If material, we believe that the facts and circumstances that led to the change in accrual should be disclosed.

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4. Loss contingencies: Measurement

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4.4 Discounting

Questions

Question 4.4.10 Can a contingent liability be discounted?

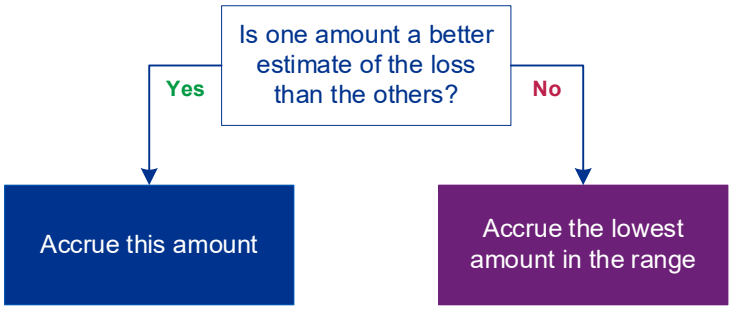
Question 4.4.20 How is the discount rate for a contingent liability selected?

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4.1 How the standard works

When a loss contingency meets the recognition criteria (see chapter 3), it becomes a contingent liability. Subtopic 450-20 requires a contingent liability to be measured based on the best estimate of the ultimate settlement amount. While requiring judgment, this estimate is not based on fair value or expected value techniques. Instead, it is simply based on the amount for which the entity expects to settle the liability.

The process for measuring a contingent liability when there is a range of possible loss is summarized in the following decision tree.



The amount of the loss is monitored and adjusted to reflect information available at each reporting date.

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4.2 Overview

Excerpt from ASC 450-20

> Dealing with Uncertainty when Accounting for Losses

05-4 Accounting standards use two primary approaches to dealing with uncertainty in loss circumstances:

a. Recognition using a probability threshold
b. Measurement using a fair value objective.

05-5 This Subtopic deals with uncertainty by requiring a probability threshold for recognition of a loss contingency and that the amount of the loss be reasonably estimable. As noted in paragraph 450-20-30-1, when both of those recognition criteria are met, and the reasonably estimable loss is a range, it requires accrual of the amount that appears to be a better estimate than any other estimate within the range, or accrual of the minimum amount in the range if no amount within the range is a better estimate than any other amount.

05-6 In contrast, fair value is not an estimate of the ultimate settlement amount or the present value of an estimate of the ultimate settlement amount. Uncertainty in the amount and timing of the future cash flows necessary to settle a liability and the likelihood of possible outcomes are incorporated into the measurement of the fair value of the liability. For example, a third party would charge a price to assume an uncertain liability even though the likelihood of a future sacrifice is less than **probable**. Similarly, when the likelihood of a future sacrifice is probable, the price a third party would charge to assume an obligation incorporates expectations about some future events that are less than probable. Recognizing 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.

05-7 Because this Subtopic deals with uncertainty differently, the recognition guidance in Section 450-20-25 is inconsistent with standards in other Topics that have an objective of measuring fair value.

A contingent liability is measured based on the best estimate of the ultimate settlement amount; this is not a fair value measurement. [450-20-05-5 – 05-6]

A contingent liability is measured at each reporting date under this measurement principle. Given the uncertainty inherent in contingent liabilities, it is quite possible that the amount of the liability will change over time as the facts and circumstances change.

Information obtained during the subsequent events period should be considered when measuring a contingent liability at the reporting date (see Question 3.6.10).

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Question 4.2.10 Why is an expected value approach not acceptable to measure contingent liabilities?

Background: An expected value considers all possible outcomes weighted based on their probabilities. This approach was historically referenced in FASB Concepts Statement No. 7, Using Cash Flow Information and Present Value in Accounting Measurements (CON 7), as the expected cash flow approach and is also referenced by IFRS Accounting Standards to measure certain provisions (i.e. recognized loss contingencies). CON 7 was superseded and the remaining Concepts Statements no longer reference this term. [former CON 7, IAS 37]

Interpretive response: The uncertainty about whether a loss has been incurred is considered when determining whether to recognize a contingent loss (see section 3.3.30 for discussion of the probability criterion). Once this determination is made, it is inappropriate to factor probability into the measurement of the resulting liability by using an expected value approach. [450-20-05-5, 30-1, FAS 143.BC35]

Question 4.2.20 Why is a fair value approach not acceptable to measure contingent liabilities?

Background: The fair value of a liability is the price that would be paid to transfer the liability in an orderly transaction between market participants at the measurement date. The price embodies expectations about future cash outflows associated with the liability from the perspective of a market participant and incorporates expectations about some future events that are less than probable. [820-10 Glossary, 450-20-05-6]

See KPMG Handbook, Fair value measurement, for additional information.

Interpretive response: The uncertainty about whether a loss has been incurred is considered when determining whether to recognize a contingent loss (see section 3.3.30 for discussion of the probability criterion). Once this determination is made, it is inappropriate to measure a contingent liability at fair value because fair value incorporates both the uncertainty in:

- the amount and timing of the future cash flows necessary to settle a liability; and
- the likelihood of possible outcomes.

Therefore, fair value is not an estimate of the ultimate settlement amount. [450-20-05-6, 30-1]

For example, assume a loss contingency has a 90% probability of settling for $1 million and a 10% chance of settling for $50,000. The fair value of this loss contingency is below $1 million because it considers the 10% chance of settlement at $50,000. However, the estimated ultimate settlement amount at which the contingent loss is recognized is $1 million.

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Question 4.2.30 When is a contingent liability remeasured?

Interpretive response: Because of the uncertainty inherent in contingent liabilities, assumptions may change over time. Therefore, the best estimate of the ultimate settlement amount needs to be revised timely as more information becomes available. When this occurs, the change in measurement is a change in accounting estimate and treated prospectively. [450-20-30-1, 250-10-45-17]

Careful consideration is needed to determine if the change in the measurement of a contingent liability is due to new facts and circumstances that arose in the current period (change in estimate), or to facts and circumstances that existed in prior periods but were not previously taken into account (correction of an error). While a change in estimate is accounted for prospectively, the correction of an error, if material to the prior-period or current-period financial statements, requires restatement of the prior-period financial statements.

For further discussion on changes in estimates and error corrections, see sections 3.4 and 4.4, respectively, in KPMG Handbook, Accounting changes and error corrections.

4.3 Determining the loss amount

Excerpt from 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.

There is limited guidance in Subtopic 450-20 on how to measure a contingent liability. The Subtopic simply requires an entity to determine the best estimate of the ultimate settlement amount. [450-20-05-5, 30-1]

Question 4.3.10 How is a contingent loss measured?

Interpretive response: The first step in measuring a contingent loss is to estimate the various possible losses. Frequently, this will produce a range of amounts. The following methodology applies when there is a range. [450-20-30-1]

One amount in a range appears to be the better estimate of the loss:	Accrue the amount that appears to be the better estimate
No amount in a range appears to be the better estimate of the loss:	Accrue the minimum amount in the range

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As a consequence of this methodology, the amount initially recognized may be different from the actual loss eventually incurred.

Estimating the various possible losses or range of possible losses typically requires judgment as does determining whether there is one possible loss in a range of possible losses that is better than the others.

Issues that may arise when measuring a contingent loss include the following.

- The expected timing of settlement is more than one year away -- see Question 4.3.20 and section 4.4 for considerations related to the effects of inflation and the time value of money, respectively.
- The contingency involves a large population of similar claims – see Question 4.3.30.
- The counterparty has made a settlement offer – see Question 4.3.40.
- Legal costs or third-party claims administration costs are expected to be incurred to resolve the contingency – see Questions 4.3.50 and 4.3.60, respectively.
- The potential for recoveries exists – see Question 4.3.70.
- Something other than cash may be transferred in settlement – see Question 4.3.80.

Question 4.3.20 How does inflation affect the measurement of a contingent liability?

Interpretive response: It may take several years for a contingent liability to be settled. Subtopic 450-20 is silent on the effect of inflation on the measurement of a contingent liability – i.e. whether the loss amount should reflect pricing conditions at the reporting date or at the expected settlement date. Consistent with the guidance on asset retirement obligations and environmental obligations, we generally believe it is appropriate to reflect inflation in the measurement of a contingent liability if it is expected that rising prices will materially affect the settlement amount. [410-20-55-13(b), 410-30-30-17]

However, there may be situations when reflecting the impact of inflation on the measurement of the contingent liability is not appropriate. This would occur when it is not practicable to estimate inflation because the timing of settlement is uncertain. [410-30-30-17]

Question 4.3.30 How is the contingent liability for a large population of similar claims estimated?

Background: As described in Question 3.5.30, the unit of account for a claim can be groups of similar types of claims, as would be the case for workers' compensation claims or class action lawsuits.

Interpretive response: In situations involving a large population of similar claims, there will ordinarily be sufficient information available to develop a range

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of loss. Typically, an actuary will be involved in developing the range. Selecting the best estimate within the range may require judgment, especially if the range is broad. We believe the approach used to select the best estimate should be documented, which includes providing an explanation of the basis for changing the approach across reporting periods.

For example, assume the actuarial range of loss is $80 to $100 in Year 1 and $90 to $110 in Year 2. The entity selects the mid-point in the Year 1 range as the best estimate in the range and accrues a contingent liability of $90 in Year 1. Applying the mid-point approach in Year 2 would increase the contingent liability to $100 in Year 2. Although $90 is still within the Year 2 range, it now represents the low end of that range. Therefore, if the entity decides to make no change to the contingent liability in Year 2, it needs to support and document why the change in approach (from mid-point to low-end) is appropriate in the circumstances.

Question 4.3.40 How do settlement offers affect the measurement of a contingent liability?

Interpretive response: In the context of litigation – either actual or threatened – a settlement offer by either party can be an important data point when measuring a contingent liability because it can constitute the best estimate or help determine the range of loss or the likelihood that a case will or will not go to trial. The relevance of settlement offers depends on the facts and circumstances – e.g. the merits of each party's case, the cost of litigation, each party's motivations for settling or not settling.

The measurement model in Topic 450 places the emphasis on the low end of the range of loss if no other amount in the range is the best estimate. As illustrated in Subtopic 450-20's Example 3, it is important to note:

- an entity's settlement offer as the defendant in litigation does not necessarily constitute the low end of the range of loss; and
- all facts and circumstances are considered in the analysis.

In that example, the entity's settlement offer was $5 million but the low end of the range was deemed to be $10 million. While it was appropriate in that example for the low end of the range to be *more than* the entity's settlement offer, we would not expect the low end of the range to be *less than* the entity's settlement offer.

Subtopic 450-20's Example 3 (paragraphs 450-20-55-36 to 55-37) is reproduced in section 3.5.40.

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Question 4.3.50 Are legal costs included in the measurement of a contingent liability?

Excerpt from ASC 450-20

> SEC Staff Guidance

• > Announcements Made by SEC Staff at Emerging Issues Task Force (EITF) Meetings

• • > SEC Staff Announcement: Accounting for Legal Costs Expected to Be Incurred in Connection with a Loss Contingency

S99-2 The following is the text of SEC Staff Announcement: Accounting for Legal Costs Expected to Be Incurred in Connection with a Loss Contingency.

Dates Discussed: January 23, 1997; March 24-25, 1999

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, 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 declined to add this potential new issue to its agenda.

The SEC Observer noted that the SEC staff would expect a registrant's accounting policy to be applied consistently and that APB Opinion No. 22, Disclosure of Accounting Policies, requires disclosure of material accounting policies and the methods of applying those policies.

Interpretive response: Topic 450 does not address the timing of recognizing legal costs associated with a contingent liability. In our experience, the following two approaches are used in practice (other than by insurance entities within the scope of Topic 944 as described below):

- recognize legal costs as incurred following general principles, independent of recognizing the related contingent liability; or
- incorporate the estimated legal costs to be incurred into the overall measurement of the contingent liability provided a reasonable estimate of those costs can be made. This approach might result in legal costs being expensed before the corresponding legal advice is received.

Consistent with the SEC staff observation reproduced above, we believe an entity should elect an accounting policy that is to be applied consistently and disclosed if material. [450-20-S99-2]

Insurance entities

An insurance entity within the scope of Topic 944 refers to the costs it incurs in the course of investigating and settling claims for the insurance contracts that it issues as 'claim adjustment expenses'. Claim adjustment expenses may include legal costs. Subtopic 944-40 requires insurance entities to record a liability for claim adjustment expenses when the insured event occurs.

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Question 4.3.60 Are third-party claims administration costs included in the measurement of a contingent liability for self-insured risks?

Interpretive response: An entity may incur third-party claims administration costs in connection with settling contingent liabilities for self-insured risks. Topic 450 does not address the accounting treatment for these costs.

Except for insurance entities within the scope of Topic 944 as described below, we believe an entity should treat third-party administration costs consistent with its accounting policy election for legal costs (see Question 4.3.50). Therefore, if an entity incorporates the estimated legal costs to be incurred in the measurement of the contingent liability, then it should also incorporate in that measurement the estimated third-party claims administration costs to be incurred.

Insurance entities

An insurance entity within the scope of Topic 944 refers to the costs it incurs in the course of investigating and settling claims for the insurance contracts that it issues as 'claim adjustment expenses'. Claim adjustment expenses may include third-party claims administration costs. Subtopic 944-40 requires insurance entities to record a liability for claim adjustment expenses when the insured event occurs.

Question 4.3.70 Are potential recoveries deducted from the measurement of a contingent liability?

Interpretive response: No. A contingent liability is measured independent of any potential recovery (e.g. insurance recovery). Even when the entity is insured, the insurance contract does not typically relieve the entity from being the primary obligor (see Question 3.7.30). Therefore, it would be inappropriate, for example, to accrue only the amount of the insurance deductible.

See section 6.2 for the accounting for amounts received as a recovery of prior losses.

Question 4.3.80 Does the nature of the resources to be transferred affect the measurement of a contingent loss?

Interpretive response: As explained in Question 3.3.30, loss contingencies are not always settled in cash. We believe caution should be exercised when resources to be transferred are not in the form of cash because the value of these resources may not always provide an adequate basis to measure the loss. For example, an entity may be involved in litigation expected to settle for $100 if paid in cash. If unable to pay this amount in cash, the entity may offer to transfer property with a carrying amount of $20 and a fair value of $110. In this

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example, we believe the loss should be measured at $100, irrespective of the carrying amount or fair value of the property.

4.4 Discounting

Excerpt from SAB Topic 5.N

Discounting by Property-Casualty Insurance Companies

Facts: A registrant which is an insurance company discounts certain unpaid claims liabilities related to short-duration[9] insurance contracts for purposes of reporting to state regulatory authorities, using discount rates permitted or prescribed by those authorities ("statutory rates") which approximate 3 1/2 percent. The registrant follows the same practice in preparing its financial statements in accordance with GAAP. It proposes to change for GAAP purposes, to using a discount rate related to the historical yield on its investment portfolio ("investment related rate") which is represented to approximate 7 percent, and to account for the change as a change in accounting estimate, applying the investment related rate to claims settled in the current and subsequent years while the statutory rate would continue to be applied to claims settled in all prior years.

Question 1: What is the staff's position with respect to discounting claims liabilities related to short-duration insurance contracts?

Interpretive Response: The staff is aware of efforts by the accounting profession to assess the circumstances under which discounting may be appropriate in financial statements. Pending authoritative guidance resulting from those efforts however, the staff will raise no objection if a registrant follows a policy for GAAP reporting purposes of:

- Discounting liabilities for unpaid claims and claim adjustment expenses at the same rates that it uses for reporting to state regulatory authorities with respect to the same claims liabilities, or
- 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.

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[9] The term "short-duration" refers to the period of coverage (*see* FASB ASC paragraph 944-20-15-7 (Financial Services — Insurance Topic)), not the period that the liabilities are expected to be outstanding.

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Excerpt from SAB Topic 5.Y

Accounting and Disclosures Relating to Loss Contingencies

Facts: A registrant believes it may be obligated to pay material amounts as a result of product or environmental remediation liability. These amounts may relate to, for example, damages attributed to the registrant's products or processes, clean-up of hazardous wastes, reclamation costs, fines, and litigation costs. The registrant may seek to recover a portion or all of these amounts by filing a claim against an insurance carrier or other third parties.

Question 1: Assuming that the registrant's estimate of an environmental remediation or product liability meets the conditions set forth in FASB ASC paragraph 410-30-35-12 (Asset Retirement and Environmental Obligations Topic) for recognition on a discounted basis, what discount rate should be applied and what, if any, special disclosures are required in the notes to the financial statements?

Interpretive Response: The rate used to discount the cash payments should be the rate that will produce an amount at which the environmental or product liability could be settled in an arm's-length transaction with a third party. Further, the discount rate used to discount the cash payments should not exceed the interest rate on monetary assets that are essentially risk free[48] and have maturities comparable to that of the environmental or product liability.

_____

[48] As described in Concepts Statement 7, Using Cash Flow Information and Present Value in Accounting Measurements.

Subtopic 450-20 is silent on whether the measurement of a contingent liability may reflect the time value of money (i.e. be discounted).

Question 4.4.10 Can a contingent liability be discounted?

Interpretive response: It depends. There is no requirement to discount a contingent liability to reflect the time value of money. However, we believe an entity may elect to discount a liability (or component thereof) if the aggregate amount of the obligation and the amount and timing of the cash payments are fixed or reliably determinable. This approach is consistent with Topic 410 for environmental remediation obligations and the SEC staff position in SAB Topics 5.N on discounting claims liabilities related to short-duration insurance contracts and 5.Y on discounting product or environmental remediation liabilities. [410-30-35-12, SAB Topic 5.N, SAB Topic 5.Y]

The 'fixed or reliably determinable' requirement is intended to be a high hurdle and is often difficult to meet in the context of loss contingencies given their inherent uncertainty. For example, we believe that it would be unusual for the amount and timing of payments to be sufficiently reliable for discounting to be permissible in the following situations:

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- early phase of litigation;
- only a range of possible losses can be estimated and no amount within that range is a better estimate than any other amount; or
- entity-specific data is not the primary data used to determine the amount and timing of cash payments.

The election to discount contingent liabilities (when appropriate) is an accounting policy to be applied consistently to similar types of contingencies and disclosed. Disclosure considerations are addressed in Question 5.3.50.

Discounting of probable loss recoveries is addressed in Question 6.2.60.

Question 4.4.20 How is the discount rate for a contingent liability selected?

Interpretive response:

SEC registrants

If an SEC registrant discounts a contingent liability (or component thereof), the SEC staff expects the registrant to select a discount rate that: [SAB Topic 5.Y]

- produces an amount at which the liability could be settled in an arm's-length transaction with a third party; and
- does not exceed the interest rate on monetary assets that are essentially risk-free and have maturities comparable to that of the liability.

Nonpublic companies

We believe the guidance for SEC registrants equally applies to nonpublic companies. In addition, it generally would be inappropriate for an entity to select a discount rate based on the entity's incremental cost of capital, incremental borrowing rate or investment portfolio yield. Further, because of different maturities and other factors in discounting contingent liabilities, it generally would be inappropriate for an entity to use the same discount rate that it uses for Topic 715 obligations (e.g. defined benefit pension plan liabilities).

However, we have observed diversity in practice in this area. For example, some nonpublic companies have a long-standing practice of discounting eligible liabilities using a settlement rate – i.e. the rate of return for a portfolio of high-quality fixed-income corporate securities with maturities consistent with the expected timing of the payments. We believe it is acceptable for a nonpublic company that has consistently applied such a policy to continue applying it.

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5. Loss contingencies: Presentation and disclosure

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Questions

Question 5.3.10 Are general statements about a loss contingency sufficient to comply with the disclosure requirements?

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Question 5.3.100 In interim financial statements, can an entity exclude loss contingency disclosures that appeared in the most recent annual financial statements?

Question 5.3.110 What disclosures about loss contingencies are required for SEC registrants under Reg S-K Item 103?

Question 5.3.120 What disclosures about loss contingencies are required for SEC registrants under Reg S-K Item 303?

Question 5.3.130 Is the availability of insurance, indemnification or contribution relevant to the Reg S-K disclosures?

Question 5.3.140 How specific are Reg S-K disclosures expected to be?

Question 5.3.150 Are loss contingencies disclosed on Form 8-K?

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5.1 How the standard works

Presentation

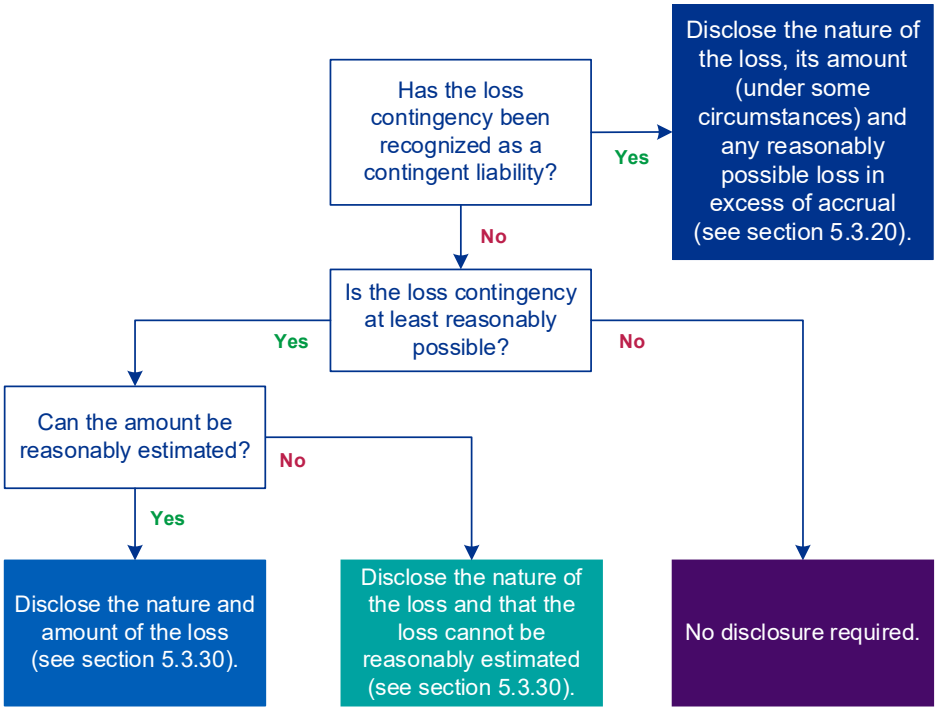
The following table summarizes the presentation requirements for loss contingencies in each financial statement.

Financial statement	Account/Activity	Presentation requirement
Balance sheet	Contingent liability	• Generally classified as current or noncurrent based on the expected period of settlement. • Not presented net of a related recovery asset except in the rare case that the right of setoff conditions in paragraph 210-20-45-1 are met (see Question 6.5.20).
Income statement	Accrual expense or release	• Classified in operating activities when the loss contingency relates to ongoing operations. • Reported in discontinued operations when the loss contingency relates to those operations. • Presented separately when the loss contingency is unusual or infrequent under Subtopic 220-20. • May be presented net of any related recovery income (see section 6.5.20).
Statement of cash flows	Cash settlement	• Classified as cash flows for operating activities (see section 5.2.30)

Disclosure

The disclosure objective of Topic 450 is to provide financial statement users with sufficient information to understand the nature and, when applicable, the amount of the contingent liability. The following decision tree summarizes the disclosure requirements.

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5.2 Presentation

5.2.10 Balance sheet

The classification of contingent liabilities as current or noncurrent is generally based on the expected period of settlement.

Question 5.2.10 How are contingent liabilities presented on a classified balance sheet?

Interpretive response: The balance sheet classification of contingent liabilities is based on the guidance in Topic 210 (balance sheet) that indicates current liabilities are "obligations whose liquidation is reasonably expected to require the use of existing resources that are classified as current assets, or the creation of other current liabilities." [210-10 Glossary]

We believe contingent liabilities are classified based on the expected period of settlement. Contingent liabilities expected to cover expenditures within the next 12 months (or the operating cycle if longer) are classified as current. Contingent liabilities that are not considered current liabilities are presented as noncurrent. [210-10-45-6, 45-9]

For additional information about balance sheet classification, see section 3.3 of KPMG Handbook, Financial statement presentation.

Example 5.2.10 Classifying a contingent liability as current or noncurrent

In a prior period, ABC recognized a contingent liability for ongoing litigation. In the current period, a court ruling is issued against ABC Corp in connection with this litigation. At year end, ABC is in the process of appealing the ruling.

If ABC does not appeal, the amount of the adverse ruling will become payable when the trial court enters the final ruling, which for this court and jurisdiction typically occurs within 12 months. However, an appeal will delay the final ruling and legal counsel has asserted that the appeals process will not be finalized within the next 12 months. Therefore, ABC classifies the contingent liability as noncurrent.

5.2.20 Income statement

The presentation of loss contingencies in the income statement relates to the corresponding accrual expense or release. Key questions include:

- where should the loss be reported – i.e. in which caption or subtotal should it be included;
- whether the loss should be separately reported from other income statement items; and

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- whether any corresponding recovery income should or can be netted with the loss.

Question 6.5.30 addresses the presentation of loss recoveries. Other presentation questions are addressed in this section.

Question 5.2.20 Are loss contingencies considered operating or nonoperating?

Interpretive response: Neither SEC guidance nor the Codification define operating, although the concept is used in both. Generally, operating activities are those activities that are part of the entity's ongoing operations. If an entity presents an operating income subtotal, it considers the nature of the loss contingency to determine if the loss should be classified in operating income.

We believe a loss from litigation arising as a result of an entity's operations generally should be classified in operating income if the entity presents such a subtotal. Conversely, losses resulting from shareholder (owner) lawsuits may be more appropriately classified as nonoperating given they arise when the value of the shareholders' general interest in the entity has been harmed.

For additional detail on what is considered operating or nonoperating, see Question 4.3.80 in KPMG Handbook, Financial statement presentation.

Question 5.2.30 How is interest accrued on a contingent liability classified in the income statement?

Interpretive response: If a contingent liability accrues interest (see section 4.4 on discounting), we believe the approach in Topic 740 (income taxes) related to classifying interest expense on uncertain tax positions should be applied. Under that Topic, interest on income tax liabilities is classified as either income tax expense or interest expense, at the entity's election. [740-10-45-25]

Applying this approach to contingent liabilities allows an entity to elect to classify interest accrued on a contingent liability as either part of the accrued loss or as interest expense. Because this choice is an accounting policy election, it must be disclosed and consistently applied.

Question 5.2.40 When are loss contingencies separately presented in the income statement?

Interpretive response: Under Subtopic 220-20, a loss is presented as a separate component of income from continuing operations when it is unusual or infrequent. [220-20-45-1]

See section 4.4 of KPMG Handbook, Financial statement presentation, for guidance on the definition and presentation of unusual or infrequently occurring items.

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Question 5.2.50 When are loss contingencies reported in discontinued operations?

Interpretive response: Loss contingencies are reported in discontinued operations in both the current and comparative periods when they are included in a disposal group reported in discontinued operations (separate from continuing operations) in the current period. Loss contingencies are included in a disposal group if they are directly associated with the assets being disposed of (e.g. legal obligations that transfer to the buyer, obligations that the potential buyer would prefer to settle for business reasons when assumed as part of the disposal group). For further guidance on which assets and liabilities are included in a disposal group, see Question 4.5.30 of KPMG Handbook, Discontinued operations and held-for-sale disposal groups. [360-10 Glossary, 360-10-15-4]

A seller may still be obligated under a loss contingency related to operations disposed of and reported as discontinued in a prior period – e.g. the seller retains legal responsibility for claims related to products sold by the discontinued operations before their disposal. Adjustments to the amounts previously reported in discontinued operations are separately presented as discontinued operations in the current-period income statement when the contingency is directly related to the discontinued operations. [205-20-45-5, S45-2, S99-2]

For further guidance regarding discontinued operations, including SEC requirements, see section 6.3.60 of KPMG Handbook, Discontinued operations and held-for-sale disposal groups.

5.2.30 Statement of cash flows

Question 5.2.60 How are cash flows for settling loss contingencies classified in the statement of cash flows?

Interpretive response: Topic 230 states that cash payments that do not stem from transactions defined as investing or financing activities, such as payments to settle lawsuits, are classified as cash flows from operating activities in the statement of cash flows. We believe this guidance is broadly applicable to payments to settle loss contingencies in the scope of Topic 450, even if settlement does not involve a lawsuit. [230-10-45-17(f)]

Accruals of expected future operating cash payments are included as noncash items in the reconciliation of net income to net cash flows from operating activities. [230-10-45-28, 45-29]

For further guidance, see section 17.4 of KPMG Handbook, Statement of cash flows.

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5.3 Disclosure

5.3.10 Overview

Section 450-20-50 has specific disclosure requirements for both recognized and unrecognized loss contingencies. The following table lists the disclosures that apply to most contingencies.

Recognized loss contingencies (section 5.3.20)	Unrecognized loss contingencies (section 5.3.30)
• Nature of loss contingency • Amount accrued (in some circumstances) • Reasonably possible loss in excess of accrual • Near term risks and uncertainties for significant estimates • SEC disclosures regarding discounted contingent liabilities	• Nature of loss contingency • Amount of potential loss • Near term risks and uncertainties for significant estimates

Additional disclosures may apply in specific circumstances (see section 5.3.40).

Question 5.3.10 Are general statements about a loss contingency sufficient to comply with the disclosure requirements?

Interpretive response: No. Over the years, the SEC staff has expressed concern that many registrants' disclosures about loss contingencies are insufficient. These concerns remain relevant not just for SEC registrants, but for all entities applying Topic 450. Among other concerns, the SEC staff has observed that general disclosures alone, such as the following statements, are insufficient. [450-20-25-2, 50-4]

- The eventual outcome of the actions against the entity will not have a material adverse effect on the financial position or results of operations.
- In the event of unexpected future developments, it is possible the ultimate resolution of those matters, if unfavorable, may be material to the entity's results of operations.

While the SEC staff has acknowledged sensitivity to disclosing confidential or prejudicial information, they have noted that sufficient information must be provided to allow investors to make an informed evaluation of the risk of loss. Some confidentiality concerns could be addressed through the aggregation of similar loss contingencies, given that disaggregation by individual matter is not required under the relevant accounting standards.

Additionally, the SEC staff has noted that entities generally may disclose the amount or range of reasonably possible losses for certain cases and indicate that it cannot estimate an amount for others.

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The areas of most frequent comment identified by the SEC staff are as follows. [2011 AICPA Conf]

- 'Surprise' disclosures or accruals are made with little or no 'foreshadowing' in previous periods (e.g. disclosure of a large litigation settlement without prior disclosures about the litigation). The SEC staff expects loss contingency disclosures, including quantitative information, to evolve over time as additional information becomes available and/or as a matter gets closer to resolution (see Question 5.3.30).
- Disclosures do not include a quantified range of loss due to the assertion that the estimate cannot be made with precision or confidence (see Question 5.3.70).
- Policies for recognizing third-party recoveries are not adequately disclosed (see Question 6.5.80).
- Policies for recognizing legal costs either as incurred or on the same basis as the related loss contingency are not disclosed (see Question 4.3.50).
- Disclosures are not written in a manner that is clear and that uses appropriate accounting terminology (i.e. remote, reasonably possible and probable).

Question 5.3.20 Are noninsurance and underinsurance of risks disclosed?

Interpretive response: Generally, no. Topic 450 does not require an entity to disclose that it is not insured (or is underinsured) with regard to any risks. Because Topic 450 is a 'catch-all' for loss contingencies, it could be very difficult to identify for disclosure purposes those uninsured (or underinsured) underlying risks that would ordinarily be insured against. This is particularly true because insurance practices are so varied. [450-20-50-7]

However, disclosure of noninsurance or underinsurance of risk is neither prohibited nor discouraged. [450-20-50-7]

Question 5.3.30 How often are contingency disclosures revised?

Interpretive response: We believe disclosures should be evaluated every reporting period and updated as necessary to reflect:

- the passage of time;
- completion of substantial milestones (e.g. settlements); and
- any newly available additional information.

If the facts and circumstances have not changed for several periods, we believe the disclosure should be updated to indicate the facts and circumstances have not changed despite the passage of time.

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Implications of not making timely updates to disclosures

Surprise disclosures or accruals of loss contingencies (see Question 5.3.10) may cause the SEC staff and others to consider if: [2004 AICPA Conf, 2010 AICPA Conf]

- appropriate disclosure was made in prior periods, including disclosure in MD&A if necessary (see section 5.3.50) – e.g. whether disclosure was provided as soon as the loss contingency became reasonably possible;
- related accruals were appropriately recognized in the period the loss contingency became probable; and
- related accruals were appropriately measured in prior periods – e.g. whether the low end of the range of possible losses was truly zero.

Illustrative SEC enforcement action

In a 2019 enforcement action, the SEC Division of Enforcement asserted that a registrant failed to timely disclose, and then accrue, a liability for the payment of significant regulatory penalties. The SEC staff noted in the enforcement action that Topic 450 requires the registrant (and its auditor) to consider the facts and circumstances each reporting period. Regulator discussions, calculations of potential damages and settlement offers may provide evidence that there is a reasonable possibility that a loss will be incurred and that disclosure is necessary. Recognizing or disclosing legal contingencies too late may result in a material error, violation of SEC rules and substantial fines.

5.3.20 Recognized loss contingencies (contingent liabilities)

Excerpt from 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.

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Excerpt from ASC 275-10

> Certain Significant Estimates

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.

A recognized loss contingency is one that meets the recognition criteria (see chapter 3) and therefore is presented as a contingent liability on the balance sheet. This section explains the required disclosures for recognized loss contingencies. Question 6.5.80 addresses disclosure requirements related to loss recoveries.

Question 5.3.40 What are the required disclosures for a contingent liability?

Interpretive response: The financial statement disclosure for a contingent liability can have several elements.

Nature of contingency

Topic 450 requires the nature of the contingency be disclosed. This does not mean a detailed explanation is always necessary. In Subtopic 450-20's Example 3, the nature of the contingency is described simply as follows: "Entity B filed a suit against the company claiming patent infringement." [450-20-50-1, 55-37]

If the contingency involves litigation that must be disclosed in the Reg S-K Item 103 section of an SEC filing (regarding legal proceedings), more detail in that section likely will be required. However, the SEC staff does not necessarily want the Subtopic 450-20 financial statement disclosures to include that additional detail (see Question 5.3.110).

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Amount accrued

The amount accrued may also need to be disclosed for the financial statements to not be misleading. [450-20-50-1]

Reasonably possible loss in excess of amount accrued

If an additional loss in excess of the accrued amount is reasonably possible, this additional loss is also disclosed, even if the amount accrued itself is not disclosed (see example under 'Near term risks and uncertainties for significant estimates'). [450-20-50-3 – 50-4]

In SEC comment letters, the SEC staff has noted that if the reasonably possible additional losses can be estimated and the amounts are not material, they will not object to a statement to that effect.

Near term risks and uncertainties for significant estimates

If information becomes known before the financial statements are issued (or available to be issued) indicating it is reasonably possible that the estimate of the probable loss (i.e. the amount accrued) could change in the near term, the entity discloses that fact if the effect of the change will be material to the financial statements. [450-20-50-2, 275-10-50-8]

Based on Topic 275's glossary, 'near term' generally means within one year. [275-10 Glossary, 275-10-50-11]

Subtopic 450-20's Example 3 illustrates this disclosure as follows.

> "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." [450-20-55-37]

In this example, this disclosure language also satisfies the requirement to disclose the reasonably possible loss in excess of the amount disclosed (discussed above). Example 3 (paragraphs 450-20-55-36 to 55-37) is reproduced in section 3.5.40.

Accounting policies

An entity also discloses accounting policy elections related to the recognition and measurement of contingent liabilities, if material, including its policies for: [235-10-50-1, SAB Topic 5.Y, 2011 AICPA Conf]

- discounting contingent liabilities (see section 4.4 and Question 5.3.50); and
- recognizing legal costs related to contingent liabilities (see Question 4.3.50).

For additional information about accounting policy disclosures, see section 6.3.20 of KPMG Handbook, Financial statement presentation.

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Question 5.3.50 What are the additional disclosures for a discounted contingent liability?

Excerpt from SAB Topic 5.Y

Accounting and Disclosures Relating to Loss Contingencies

Question 1: Assuming that the registrant's estimate of an environmental remediation or product liability meets the conditions set forth in FASB ASC paragraph 410-30-35-12 (Asset Retirement and Environmental Obligations Topic) for recognition on a discounted basis, what discount rate should be applied and what, if any, special disclosures are required in the notes to the financial statements?

Interpretive Response: …

If the liability is recognized on a discounted basis to reflect the time value of money, 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. Material changes in the expected aggregate amount since the prior balance sheet date, other than those resulting from pay-down of the obligation, should be explained.

Interpretive response: Question 1 of SAB Topic 5.Y (reproduced directly above) lists a number of disclosures that the SEC staff expects when a registrant discounts an environmental remediation liability or product liability. We believe any entity that has discounted contingent liabilities (not just discounted contingent product liabilities) should also make these disclosures and indicate in its accounting policies that it has elected to discount eligible contingent liabilities. See section 4.4 for guidance on when discounting may be permitted.

5.3.30 Unrecognized loss contingencies

Excerpt from ASC 450-20

> Unrecognized Contingencies

50-2A The disclosures required by paragraphs 450-20-50-3 through 50-6 do not apply to credit losses on instruments within the scope of Topic 326 on measurement of credit losses. (See paragraph 310-10-50-21.)

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.

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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.

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.

50-8 No disclosure about general or unspecified business risks is required by this Subtopic, however, Topic 275 requires disclosure of certain business risks.

An unrecognized loss contingency is one that is not probable of occurring and/or reasonably estimable (see chapter 3). Certain unrecognized loss contingencies are disclosed, as explained in this section.

Question 5.3.60 When are disclosures required for unrecognized loss contingencies?

Interpretive response: The following chart summarizes unrecognized loss contingency conditions and whether a disclosure is required.

Condition	Disclosure required?
Loss contingency that is at least reasonably possible, but a liability has not been accrued because one or both the probable and reasonably estimable	Yes (see Question 5.3.70) [450-20-50-3]

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Condition	Disclosure required?
criteria in paragraph 450-20-25-2 are not met (see chapter 3)	
Loss contingency that involves an unasserted claim or assessment for which there is no indication that a potential claimant is aware of the possible claim or assessment (see section 3.5.20)	It depends. Disclosure required if: [450-20-50-6] • it is considered probable that a claim will be asserted; and • there is a reasonable possibility that the outcome will be unfavorable.
Remote loss contingency (see section 3.3.30)	No [450-20-50-3]
Noninsured or underinsured risks	No (see Question 5.3.20) [450-20-50-7]
General or unspecified business risks	Not required by Topic 450; however, Topic 275 (risks and uncertainties) requires disclosures of certain business risks

Question 5.3.70 What are the required disclosures for an unrecognized loss contingency?

Interpretive response: When required (see Question 5.3.60), the financial statement disclosure for an unrecognized loss contingency can have several elements.

Nature of contingency

Topic 450 requires disclosing the nature of the contingency, similar to the requirements for recognized loss contingencies (see Question 5.3.40). [450-20-50-4(a)]

Amount of potential loss

If a contingent loss is probable but has not been accrued because it cannot be reasonably estimated, the entity discloses that the contingent loss cannot be estimated. [450-20-50-4(b)]

If a contingent loss is reasonably possible but not probable (and therefore not accrued), the entity discloses the estimated possible loss or range of loss or a statement that such an estimate cannot be made. [450-20-50-4(a)]

Over the years, the SEC staff has expressed concern that registrants have not disclosed the reasonably possible range of loss because they assert that they are unable to make such an estimate with precision or confidence. Neither 'precision' nor 'confidence' is included in the relevant standards; thus, registrants should not assert this as a basis for not disclosing a reasonably possible range of loss.

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Near term risks and uncertainties for significant estimates

If information becomes known before the financial statements are issued (or available to be issued) indicating it is reasonably possible that the estimate of the loss or range of loss could change in the near term, the entity discloses that fact if the effect of the change will be material to the financial statements. Based on Topic 275's glossary, 'near term' generally means within one year. [275-10 Glossary, 275-10-50-11]

5.3.40 Disclosures in specific circumstances

Question 5.3.80 What disclosures are required if a subsequent event occurs and results in a contingent loss?

Excerpt from ASC 450-20

• > Losses Arising After the Date of the Financial Statements

50-9 Disclosure of a loss, or a loss contingency, arising after the date of an entity's financial statements but before those financial statements are issued, as described in paragraphs 450-20-25-6 through 25-7, may be necessary to keep the financial statements from being misleading if an accrual is not required. If disclosure is deemed necessary, the financial statements shall include both of the following:

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

50-10 Occasionally, in the case of a loss arising after the date of the financial statements if the amount of asset impairment or liability incurrence can be reasonably estimated, disclosure may best be made by supplementing the historical financial statements with pro forma financial data giving effect to the loss as if it had occurred at the date of the financial statements. It may be desirable to present pro forma statements, usually a balance sheet only, in columnar form on the face of the historical financial statements.

Interpretive response: Disclosure is required if a loss or loss contingency arises after the reporting date but before the financial statements are issued (or available to be issued) and providing no disclosure could cause the financial statements to be misleading. The required disclosure includes both: [450-20-50-9]

- the nature of the loss or loss contingency; and
- an estimate of the amount or range of loss or possible loss, or a statement that such an estimate cannot be made.

By contrast, events or transactions that provide additional evidence about a loss or loss contingency that existed at the reporting date (i.e. recognized subsequent events – see section 3.6) do not require specific disclosures.

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However, their effects are captured within the required disclosures for the affected contingent liabilities.

Question 5.3.90 What is disclosed for recorded and unrecorded product liabilities?

Excerpt from SAB Topic 5.Y

Accounting and Disclosures Relating to Loss Contingencies

Question 2: What financial statement disclosures should be furnished with respect to recorded and unrecorded product or environmental remediation liabilities?

Interpretive Response: FASB ASC Section 450-20-50, Contingencies—Loss Contingencies—Disclosure, identifies disclosures regarding loss contingencies that generally are furnished in notes to financial statements. FASB ASC Section 410-30-50, Asset Retirement and Environmental Obligations—Environmental Obligations—Disclosure, identifies disclosures that are required and recommended regarding both recorded and unrecorded environmental remediation liabilities. The staff believes that product and environmental remediation liabilities typically are of such significance that detailed disclosures regarding the judgments and assumptions underlying the recognition and measurement of the liabilities are necessary to prevent the financial statements from being misleading and to inform readers fully regarding the range of reasonably possible outcomes that could have a material effect on the registrant's financial condition, results of operations, or liquidity. In addition to the disclosures required by FASB ASC Section 450-20-50 and FASB ASC Section 410-30-50, examples of disclosures that may be necessary include:

- Circumstances affecting the reliability and precision of loss estimates.
- The extent to which unasserted claims are reflected in any accrual or may affect the magnitude of the contingency.
- Uncertainties with respect to joint and several liability that may affect the magnitude of the contingency, including disclosure of the aggregate expected cost to remediate particular sites that are individually material if the likelihood of contribution by the other significant parties has not been established.
- Disclosure of the nature and terms of cost-sharing arrangements with other potentially responsible parties.
- The extent to which disclosed but unrecognized contingent losses are expected to be recoverable through insurance, indemnification arrangements, or other sources, with disclosure of any material limitations of that recovery.
- Uncertainties regarding the legal sufficiency of insurance claims or solvency of insurance carriers.[49]
- The time frame over which the accrued or presently unrecognized amounts may be paid out.
- Material components of the accruals and significant assumptions underlying estimates.

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Registrants are cautioned that a statement that the contingency is not expected to be material does not satisfy the requirements of FASB ASC Topic 450 if there is at least a reasonable possibility that a loss exceeding amounts already recognized may have been incurred and the amount of that additional loss would be material to a decision to buy or sell the registrant's securities. In that case, the registrant must either (a) disclose the estimated additional loss, or range of loss, that is reasonably possible, or (b) state that such an estimate cannot be made.

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[49] 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.

Interpretive response: When a registrant has a material product liability – either recognized or unrecognized – the SEC staff typically expects the financial statement disclosures to go beyond what is required by Topic 450. The potential additional disclosures are listed in Question 2 of SAB Topic 5.Y (reproduced directly above).

Question 5.3.100 In interim financial statements, can an entity exclude loss contingency disclosures that appeared in the most recent annual financial statements?

Interpretive response: No. Loss contingencies and other uncertainties that could affect the fairness of interim presentation of financial information are disclosed in interim financial statements consistent with annual requirements. These disclosures are repeated in interim and annual periods until the contingency is resolved or becomes immaterial. [270-10-50-6]

For additional information about interim reporting, see section 10 of KPMG Handbook, Financial statement presentation.

5.3.50 Disclosures outside of the financial statements

In addition to the disclosures provided in the financial statements under Topic 450, a registrant may need to discuss loss contingencies outside of the financial statements. Registrants should consider the requirements of the following items in Reg S-K:

- Item 101 (description of business);
- Item 103 (legal proceedings); and
- Item 303 (MD&A).

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Question 5.3.110 What disclosures about loss contingencies are required for SEC registrants under Reg S-K Item 103?

Interpretive response: Reg S-K Item 103 requires a registrant to disclose any material pending legal proceedings other than ordinary routine litigation that is incidental to its business. That guidance provides materiality considerations for required disclosures and additional discussion on the meaning of 'other than ordinary routine litigation that is incidental to the registrant's business'. [S-K Item 103(a)]

The objectives of Topic 450's disclosure requirements are different from the objectives of Item 103's disclosure requirements. For example, the Item 103 disclosures are made about litigation that is deemed material, regardless of whether the registrant determines that its potential liability associated with the litigation is probable or reasonably possible. Further, Item 103 disclosures can also be required when the registrant is the plaintiff in litigation. [S-K Item 103(a)]

In addition, Item 103 requires a registrant to disclose "the name of the court or agency in which the proceedings are pending, the date instituted, the principal parties thereto, a description of the factual basis alleged to underlie the proceedings and the relief sought." [S-K Item 103(a)]

When litigation triggers disclosure under both Topic 450 and Item 103, the SEC staff has observed that some registrants attempt to satisfy the disclosure objectives of both provisions with a single set of disclosures presented in the Item 103 section that is then repeated in the notes to the financial statements. However, this often results in lengthy factual disclosures that provide little insight into the underlying loss contingency, the related exposure and the likelihood of loss. Therefore, registrants may find that they need to provide different disclosure language in the financial statement notes than in the Item 103 section of their filing.

Question 5.3.120 What disclosures about loss contingencies are required for SEC registrants under Reg S-K Item 303?

Interpretive response: MD&A disclosures required by Reg S-K Item 303 provide information to allow financial statement users to assess the registrant's financial condition and results of operations. This includes information that aids in evaluating the amounts and certainty of cash flows from operations and from outside sources. The disclosures focus on material events, contingent items and uncertainties known to management that are reasonably likely to cause reported financial information not to be indicative of future financial results or financial conditions or that would affect an entity's liquidity or financial position. [S-K Item 303(a)]

A registrant considers the disclosure requirements throughout the life cycle of an uncertainty to ensure timely disclosure of the information required by Item 303. For example, the accrual for a material loss contingency should not be the

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first disclosure about the contingency when the related event occurred many years ago.

We believe that the various disclosure requirements of MD&A are generally satisfied if the required disclosures under Topic 450 for recognized contingencies have been appropriately made.

Question 5.3.130 Is the availability of insurance, indemnification or contribution relevant to the Reg S-K disclosures?

Excerpt from SAB Topic 5.Y

Accounting and Disclosures Relating to Loss Contingencies

Question 3: What disclosures regarding loss contingencies may be necessary outside the financial statements?

Interpretive Response: Registrants should consider the requirements of Items 101 (Description of Business), 103 (Legal Proceedings), and 303 (MD&A) of Regulation S-K. The Commission has issued interpretive releases that provide additional guidance with respect to these items.[50]

In a 1989 interpretive release, the Commission noted that the availability of insurance, indemnification, or contribution may be relevant in determining whether the criteria for disclosure have been met with respect to a contingency.[51]

The registrant's assessment in this regard should include consideration of facts such as the periods in which claims for recovery may be realized, the likelihood that the claims may be contested, and the financial condition of third parties from which recovery is expected. …

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[50] references the interpretative releases Securities Act Release No. 6130, FR 36, Securities Act Release No. 33-8040, Securities Act Release No. 33-8039, and Securities Act Release No. 33-8176.

[51] references the interpretative release footnote 30 of FR 36 (footnote 17 of Section 501.02 of the Codification of Financial Reporting Policies).

Interpretive response: Yes. SEC registrants consider the availability of insurance, indemnification or contribution in determining whether the criteria for disclosure under Reg S-K have been met with respect to a contingency. The registrant's assessment includes consideration of facts such as: [SAB Topic 5.Y]

- the periods in which claims for recovery may be realized;
- the likelihood that the claims may be contested; and
- the financial condition of third parties from which recovery is expected.

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Question 5.3.140 How specific are Reg S-K disclosures expected to be?

Excerpt from SAB Topic 5.Y

Accounting and Disclosures Relating to Loss Contingencies

Question 3: What disclosures regarding loss contingencies may be necessary outside the financial statements?

Interpretive Response: Registrants should consider the requirements of Items 101 (Description of Business), 103 (Legal Proceedings), and 303 (MD&A) of Regulation S-K. …

Disclosures made pursuant to the guidance identified in the preceding paragraph should be sufficiently specific to enable a reader to understand the scope of the contingencies affecting the registrant. For example, a registrant's discussion of historical and anticipated environmental expenditures should, to the extent material, describe separately (a) recurring costs associated with managing hazardous substances and pollution in on-going operations, (b) capital expenditures to limit or monitor hazardous substances or pollutants, (c) mandated expenditures to remediate previously contaminated sites, and (d) other infrequent or non-recurring clean-up expenditures that can be anticipated but which are not required in the present circumstances. Disaggregated disclosure that describes accrued and reasonably likely losses with respect to particular environmental sites that are individually material may be necessary for a full understanding of these contingencies. Also, if management's investigation of potential liability and remediation cost is at different stages with respect to individual sites, the consequences of this with respect to amounts accrued and disclosed should be discussed.

Examples of specific disclosures typically relevant to an understanding of historical and anticipated product liability costs include the nature of personal injury or property damages alleged by claimants, aggregate settlement costs by type of claim, and related costs of administering and litigating claims. Disaggregated disclosure that describes accrued and reasonably likely losses with respect to particular claims may be necessary if they are individually material. If the contingency involves a large number of relatively small individual claims of a similar type, such as personal injury from exposure to asbestos, disclosure of the number of claims pending at each balance sheet date, the number of claims filed for each period presented, the number of claims dismissed, settled, or otherwise resolved for each period, and the average settlement amount per claim may be necessary. Disclosures should address historical and expected trends in these amounts and their reasonably likely effects on operating results and liquidity.

Interpretive response: The SEC staff expects Reg S-K disclosures about loss contingencies to be sufficiently specific to enable a reader to understand the scope of the contingencies. [SAB Topic 5.Y]

The SAB is written in the context of product and environmental remediation liabilities, but we believe it applies broadly to loss contingencies. The SAB lists

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the following examples of specific disclosures typically relevant to an understanding of historical and anticipated product liability costs:

- the nature of personal injury or property damages alleged by claimants;
- the aggregate settlement costs by type of claim; and
- the related costs of administering and litigating claims.

If an individual accrued or reasonably likely loss is material, the SEC staff expects separate disclosure of that loss. Further, if the contingency involves a large number of relatively small individual claims of a similar type, such as personal injury from exposure to asbestos, disclosure of the following may be necessary:

- the number of claims pending at each reporting date;
- the number of claims filed for each period presented;
- the number of claims dismissed, settled or otherwise resolved for each period; and
- the average settlement amount per claim.

Disclosures must address historical and expected trends in these amounts and their reasonably likely effects on operating results and liquidity. [SAB Topic 5.Y (Q3)]

Question 5.3.150 Are loss contingencies disclosed on Form 8-K?

Interpretive response: It depends. Form 8-K is filed to disclose many events that affect a registrant, including the following two events that often relate to loss contingencies.

Event	Examples of disclosures may include…
An event that causes the increase or acceleration of a direct financial obligation, the consequences of which are material to the registrant [Form 8-K (Item 2.04)]	• the date of the triggering event; • a brief description of the triggering event; and • the amount of the direct financial obligation and other material obligations that may arise.
A conclusion by management or the board that a material charge for impairment to one or more of its assets is required under GAAP [Form 8-K (Item 2.06)]	• the date of the conclusion that a material charge is required; • a description of the impaired asset and facts and circumstances leading to the conclusion that the impairment charge is required; and • an estimate of the amount or range of amounts of the impairment charge.

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6. Gain contingencies and loss recoveries

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Example 6.4.10 Insurance recovery related to business interruption

Example 6.4.20 Business interruption claim settled after the reporting date and mixed model applies

Example 6.4.30 Insurance settlement before all losses are incurred

6.5 Presentation and disclosure

6.5.10 Balance sheet

6.5.20 Income statement

6.5.30 Statement of cash flows

6.5.40 Disclosures

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Questions

Question 6.5.10 How are assets recognized under the gain contingency or loss recovery model presented on a classified balance sheet?

Question 6.5.20 Can a liability be presented net of a related insurance recovery?

Question 6.5.30 How are gain contingencies and loss recoveries presented in the income statement?

Question 6.5.40 How are gains and losses from involuntary conversions presented in the income statement?

Question 6.5.50 How are the proceeds from business interruption insurance presented in the income statement?

Question 6.5.60 How are cash flows from the settlement of insurance claims classified?

Question 6.5.70 What disclosures should be considered for gain contingencies?

Question 6.5.80 What disclosures are required for loss recoveries, including business interruption insurance recoveries?

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6.1 How the standard works

Gain contingencies and loss recoveries are accounted for under two different accounting models, but sometimes both models are applied to the same transaction (see discussion of the mixed model below).

Loss recovery model

Recoveries of costs and losses incurred are accounted for under the loss recovery model when there is direct linkage to the loss event. The model typically applies to insured losses – e.g. those related to involuntary conversions, workers' compensation claims and environmental matters.

Under the loss recovery model, a recovery is recognized when it is probable and reasonably estimable. The amount of the recovery recognized is capped at the amount of the costs and losses incurred (i.e. recognized). Probable means likely to occur, as defined in Subtopic 450-20 regarding loss contingencies.

Gain contingency model

A gain contingency is an existing condition, situation or set of circumstances involving uncertainty as to possible gain that will ultimately be resolved when one or more future events occur or fail to occur.

A gain contingency is not recognized before its realization. Realization requires resolution of all uncertainties and is typically when cash or a claim to cash is received.

Unlike for loss contingencies and loss recoveries, probability is not a factor in the recognition of gain contingencies. Therefore, gain contingencies are typically recognized later than loss contingencies and loss recoveries, even when they relate to the same loss event.

Mixed model

Some transactions involving the recovery of losses are bifurcated, with:

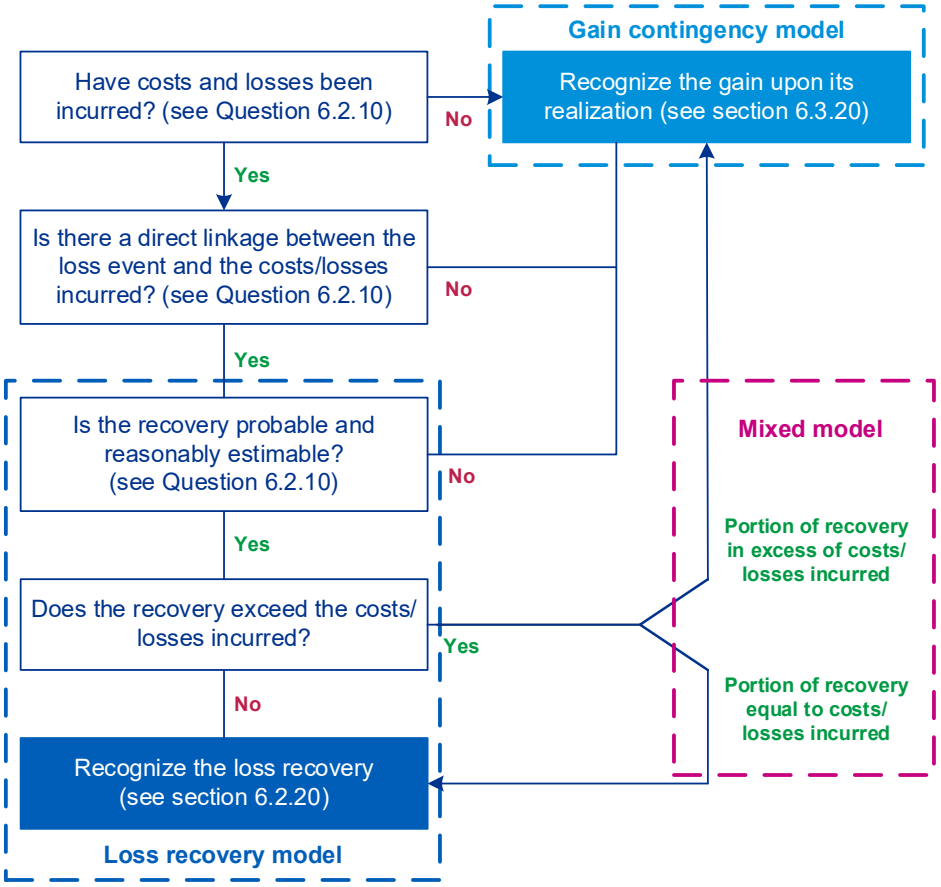
- the loss recovery model applying to the anticipated recovery of costs and losses incurred (with a direct linkage to the loss event); and
- the gain contingency model applying to any remaining amount of the anticipated recovery.

The mixed model often applies to recoveries from business interruption insurance.

Summary

The following diagram summarizes the decision points involved in accounting for a loss recovery and gain contingency.

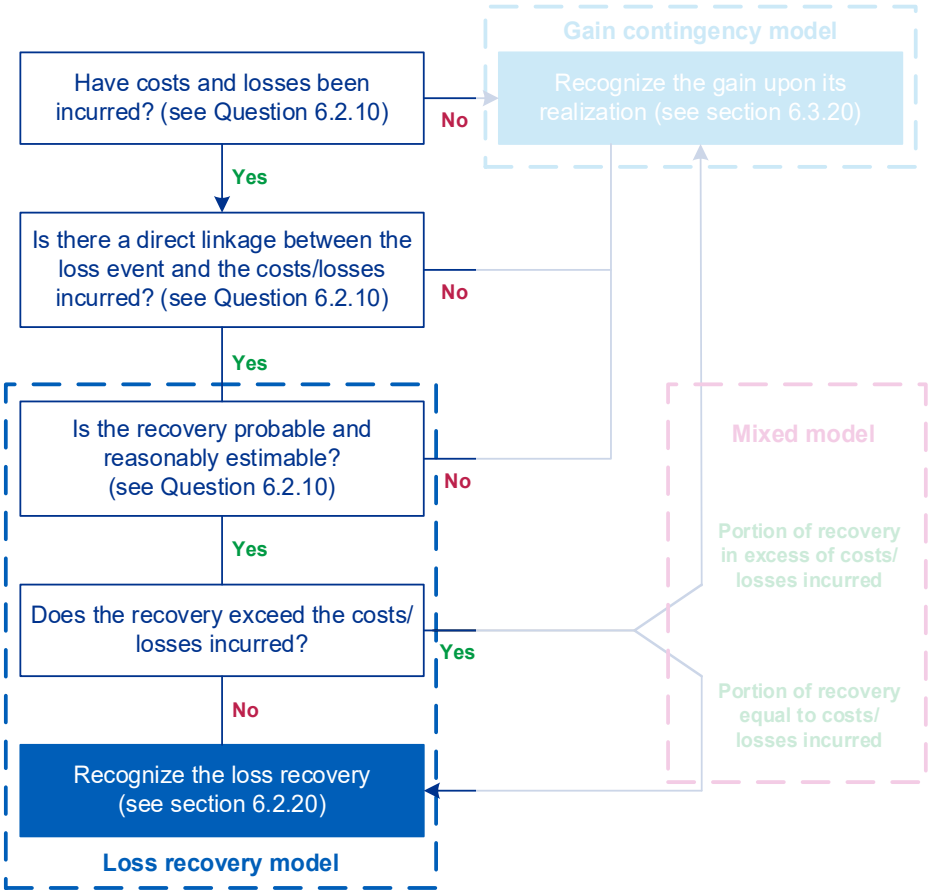
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6.2 Loss recoveries

Provided below is a diagram that addresses the applicability of the loss recovery model and the accounting under that model.



6.2.10 Overview

Recoveries of costs and losses incurred (up to the amount of those costs and losses) are accounted for under the loss recovery model when there is direct linkage to the loss event. The model typically applies to insured losses related to involuntary conversions, workers' compensation claims and environmental matters.

Question 6.2.10 When is a loss recovery recognized under the loss recovery model?

Interpretive response: The loss recovery model applies and a recovery is recognized when the following criteria are met (which is typically before the funds are received).

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Applicability criteria	
Incurred costs and losses	Costs and losses must have been incurred (i.e. previously recognized in the financial statements). This may be through asset impairments or accrual of the corresponding loss contingency.
Direct linkage	The recovery must have direct linkage to the loss event and the costs and losses incurred.
Recognition criteria	
Probable	Recovery must be probable, which means 'likely to occur', as defined in Topic 450 (see section 3.3.30).
Reasonably estimable	The amount of the recovery must be reasonably estimable.

When these criteria are not met, the potential recovery is considered a gain contingency, subject to the accounting model described in section 6.3. It is also possible that both the loss recovery model and the gain contingency model apply – the mixed model (see Question 6.3.20).

Question 6.2.20 What is the basis for the loss recovery model?

Interpretive response: The loss recovery model is largely derived by analogy to Subtopic 410-30 (environmental obligations) and Subtopic 450-20 (loss contingencies) and builds on the guidance in Subtopic 610-30 (involuntary conversions). The concepts in this model were indirectly confirmed by the FASB in superseded EITF 01-10, Accounting for the Impact of the Terrorist Attacks of September 11, 2001.

Analogy to Subtopics 410-30 and 450-20

Paragraph 410-30-35-8 states:

> "[t]he 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."

This guidance relies on the same definition of 'probable' used for loss contingencies (see section 3.3.30) and is applied by analogy to loss recoveries in general. Meeting the probability threshold could result in an entity recognizing a recovery up to the costs and losses incurred in the same reporting period that those costs and losses are recognized (when they are incurred or accrued under the loss contingency model in Subtopic 450-20). By analogy to the guidance for loss contingencies, the recovery must also be reasonably estimable to be recognized. [410-30-35-8]

Further, Subtopic 410-30 speaks to potential recoveries of 'amounts expended'. Therefore, the loss recovery model is applicable only when the costs and losses have been incurred and the recovery is directly related to the insured event (see the applicability criteria in Question 6.2.10). [410-30-35-8]

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Interrelationship with involuntary conversions

Subtopic 610-30 applies when nonmonetary assets (such as property or equipment) are involuntarily converted to monetary assets (such as insurance proceeds) used to reinvest in other nonmonetary assets. Involuntary conversion can result from total or partial destruction, theft, seizure or condemnation. While Subtopic 610-30 does not specifically address recoveries of costs and lost margin associated with interruption of an entity's business, we believe those recoveries should be accounted for using methods similar to those used for recoveries of losses on nonmonetary assets. [610-30-05-1, 15-2]

Subtopic 610-30 provides that a gain or loss from an involuntary conversion is recognized as a separate transaction, irrespective of the use of the recovered proceeds. The cost of subsequently acquired nonmonetary assets is measured by the consideration paid and not affected by the involuntary conversion. [610-30-25-2 – 25-3, 30-1]

Subtopic 610-30 does not directly address when the recovery is recognized. However, it acknowledges that a nonmonetary asset may be destroyed or damaged in one accounting period, and the amount of monetary assets to be received may not be determinable until a subsequent accounting period. In this case, Subtopic 610-30 indicates Topic 450 applies. Therefore, we believe the recovery in an involuntary conversion should be assessed under the loss recovery model discussed above. However, any excess of the recovery over the costs or loss incurred should be assessed under the gain contingency model discussed in section 6.3.10. [610-30-25-4]

6.2.20 Application of the loss recovery model

Question 6.2.30 How is direct linkage assessed?

Interpretive response: Direct linkage is assessed by reference to the relationship between the recovery, the loss event and the costs and losses incurred. There must be a direct link between all three to meet the related criterion (see Question 6.2.10).

Depending on the nature of the event and recovery, establishing direct linkage may require judgment. For example, it may be challenging to demonstrate linkage when the event spans multiple periods or involves different types of insurance coverage or carriers, or when the entity expects a lump sum payment from the insurer to settle several claims.

Further, an entity needs to consider which costs and losses (e.g. fixed costs) incurred and recognized in the financial statements are directly attributable to the insured event. Among other factors, this could require considering the period of insurance coverage, the time value of money, any applicable insurance deductible and any transaction costs incurred to obtain the recovery. [410-30-35-10, 30-19]

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Question 6.2.40 How is the probability of a loss recovery assessed?

Interpretive response: Assessing the probability of a loss recovery may require significant judgment. For example, we believe receipt of payment by itself may not always establish that the recovery is probable, such as when the payment could be contested or subject to refund. Conversely, we believe an insurance recovery could be established as probable before the entity files the insurance claim.

To establish the probability of a recovery, we believe an entity should consider all relevant facts and circumstances, such as:

- whether the loss event is insured under the applicable policy terms and the history of successful recovery under these terms for similar events;
- the applicable deductible; and
- the creditworthiness of the counterparty.

An entity should also consider obtaining direct confirmation of the insurance coverage available for the loss event from the insurance carrier or legal counsel.

Loss recovery subject to dispute or litigation

Coverage disputes between insurers and insured entities may arise from differences in interpretation of matters such as:

- the date of loss relative to the insurance coverage period;
- the nature of the loss relative to policy exclusions;
- the timeliness of the insured reporting the loss to the insurer under the policy terms; and
- whether a significant loss event constitutes a single loss or multiple losses under the policy, each subject to a deductible.

Subtopic 410-30 provides that if an insurance claim related to an environmental obligation is the subject of dispute or litigation, a rebuttable presumption exists that the realization of the claim is not probable. Further, the SEC staff believes there is a rebuttable presumption that a claim for recovery cannot be recognized if the counterparty is asserting that it is not liable for the recovery. [410-30-35-9, SAB Topic 5.Y (fn 49)]

The SEC staff's rebuttable presumption is applied by analogy to disputes and litigation related to loss recoveries in general, not just to those involving environmental obligations. If the presumption is not overcome, then the potential recovery is accounted for as a gain contingency (see Question 6.3.60 for a litigation-related consideration). If this presumption is overcome, specific disclosures apply (see Question 6.5.80). [SAB Topic 5.Y (fn 49)]

Question 6.2.50 When is a loss recovery reasonably estimable?

Interpretive response: Determining whether a loss recovery is reasonably estimable is based on the same analysis applied to determine whether a

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contingent loss is reasonably estimable. Question 3.4.10 highlights a number of factors relevant to both of these analyses.

Because the loss recovery model only applies when costs and losses have been incurred in the loss event, these costs and losses typically provide a basis to conclude that a reasonable estimate of the expected recovery can be made. However, there may be situations where a reasonable estimate of a recovery cannot be established even when related costs and losses have been incurred – for example, when damages are still being assessed in the early stages of a loss event, or if the applicable insurance coverage is unclear.

Question 6.2.60 How is a loss recovery measured?

Interpretive response: A probable loss recovery is measured at its reasonably estimable amount but is capped at the amount of costs and losses incurred in the loss event. However, there are circumstances when the loss recovery is lower than the costs and losses incurred, such as when a deductible applies under the related insurance policy. When there is uncertainty about the total amount to be recovered, we believe that the measurement of the loss recovery recognized should be limited to the amount that is probable of being recovered.

The amount recognized for a loss recovery may need to be revised over time as additional recoverable costs and losses are incurred, or the terms of the recovery (e.g. the insurance coverage) are clarified.

Litigation costs incurred to obtain a recovery are included in the loss recovery if it is probable they will be recovered. Determining what legal costs are recoverable requires judgment and depends on facts and circumstances. [410-30-30-14]

Consistent with the guidance in Topic 410 for probable recoveries of environmental remediation costs, we believe an entity should not discount probable recovery amounts unless the liability itself is discounted (see section 4.4) and the timing of the recovery depends on the timing of the payment. [410-30-30-19]

Question 6.2.70 How does Topic 855 on subsequent events apply to loss recoveries?

Background: Subsequent events are events or transactions that occur after the reporting date but before the financial statements are issued or are available to be issued (i.e. the subsequent events period). Subsequent events are categorized into two broad types: recognized events (Type 1) and nonrecognized events (Type 2). See section 3.6. [855-20 Glossary, 855-10-25-1]

Interpretive response: Because Topic 855's framework applies to loss recoveries, if a subsequent event provides evidence that a loss recovery was probable and reasonably estimable at the reporting date, the loss recovery is recognized at that date.

When the subsequent event does not provide evidence that a loss recovery was probable and reasonably estimable at the reporting date, it is a

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nonrecognized subsequent event. However, Topic 855 disclosures may be required. See section 3.6 for additional information about Topic 855 and see section 9.5.20 of KPMG Handbook, Financial statement presentation.

For example, an insurance settlement after the reporting date may confirm that the recovery of costs previously incurred was probable at the reporting date. We believe the settlement amount should be considered in estimating the recovery recognized at the reporting date.

In contrast, amounts recovered after the reporting date in excess of a loss or costs incurred at the reporting date are gain contingencies and nonrecognized subsequent events as of the reporting date (see Question 6.3.50).

Example 6.2.10 Insurance recovery settled after the reporting date, loss recovery model applies

ABC Corp suffers equipment damage due to a natural disaster. The following facts are relevant.

- **December 1, Year 1:** ABC's equipment is destroyed by a hurricane. The equipment has a net book value of $1,500 and an estimated replacement cost of $1,600. ABC files a claim with its insurer shortly thereafter.
- **December 31, Year 1 (reporting date):** Based on discussions with the insurer, ABC concludes that insurance recoveries of at least $1,200 are probable.
- **February 1, Year 2:** ABC receives payment of $1,300 from the insurer as final settlement for the claim.
- **March 15, Year 2:** December 31, Year 1 financial statements are issued.

In its Year 1 financial statements, ABC writes off the net book value of the destroyed equipment of $1,500 as a loss under Subtopic 610-30. The settlement confirms that the recovery of costs previously incurred was probable at the reporting date. ABC considers the amount of the settlement in its estimate and recognizes an asset of $1,300 for the probable recovery of its loss.

Question 6.2.80 How is a reduction of the amount of non-income-based taxes payable accounted for when uncertainties about the reduction exist?

Background: See section 3.7.40 for discussion of how the accounting for non-income-based taxes (e.g. sales tax, property tax) is affected when there is uncertainty related to the entity having an *obligation* to pay the tax.

Interpretive response: In some situations, an entity may be entitled to a reduction of the amount of non-income-based taxes payable as long as it meets certain criteria (e.g. presence, minimum employment levels, pollution control). The reduction of the non-income-based taxes payable may be in the form of an abatement or refund (see Question 6.2.90 regarding refundable credits for non-

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income-based taxes). When there are uncertainties about whether the entity meets the criteria for the reduction in non-income-based taxes, we believe the reduction should be evaluated under the loss recovery model and should not be accounted for as a government grant (see Question 6.3.30).

Accordingly, before recognizing any benefit from a reduction in non-income-based taxes, the entity must meet the requirements to qualify for the reduction and it should be probable that the contingent recovery will be both sustained by the taxing authority and realized by the entity.

If an entity is unable to conclude that the reduction in non-income-based taxes is probable of being sustained and realized, it does not recognize the benefit. The entity also considers the disclosure requirements in Topic 450 (see section 6.5) and Topic 275 (see section 7.2 in KPMG Handbook, Financial statement presentation).

Recognition of the benefit from the reduction in non-income-based taxes occurs beginning in the period the entity concludes it is probable that a reduction in non-income-based taxes will be sustained and realized. In addition, when the tax:

- **is *not* related to the use of property,** we believe the entity should generally recognize the benefit in the period(s) of the benefit. For example, if the benefit is intended to *compensate* the entity for maintaining minimum employment levels over a specific term, it might be appropriate to recognize the benefit over that term. In many instances this will have the same effect as recognizing the benefit in the period it becomes available, similar to the accounting for income tax holidays in Topic 740 (see paragraph 3.090 in KPMG Handbook, Accounting for income taxes). [740-10-25-35]
- **is related to the use of property,** we believe it is preferable in many instances to recognize the benefit over the life of the related property (the *deferral method* in Topic 740) (see section 4.2.30 in KPMG Handbook, Tax credits). [740-10-25-45 – 25-46]

Finally, if the entity were to subsequently determine that a previously recognized reduction in non-income-based taxes is no longer probable of being sustained or realized, any benefit previously recognized is reversed through the income statement in the current period.

Question 6.2.90 How is a refundable credit of non-income-based taxes accounted for?

Interpretive response: It depends. There may be situations in which a government provides an entity with a credit against its non-income-based taxes (instead of an abatement or refund – see Question 6.2.80) as long as it meets certain criteria. Uncertainties may exist about whether the entity meets the criteria for the credit.

If the credit is not limited to the amount of the non-income tax liability (i.e. the excess of the credit over the tax liability is refundable to the entity), we believe the credit is accounted for as a government grant (see Question 6.3.30).

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Otherwise, the loss recovery model applies to the credit, similar to a non-income-based tax abatement or refund (see Question 6.2.80).

For example, the Coronavirus Aid, Relief, and Economic Security Act granted eligible entities an employee retention credit against applicable payroll taxes for each calendar quarter in an amount equal to 50% of qualified wages. Eligible amounts that exceeded an entity's applicable payroll tax liability were refundable to the entity. We believe this credit should be accounted for as a government grant in its entirety – see Question 6.3.30 for further discussion of government grant accounting.

6.3 Gain contingencies

6.3.10 Overview

Excerpt from ASC 450-30

> Overall Guidance

15-1 This Subtopic follows the same Scope and Scope Exceptions as outlined in the Overall Subtopic, see Section 450-10-15.

20 Glossary

Gain Contingency

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.

Gain contingencies are accounted for under Subtopic 450-30. To be in the scope of Subtopic 450-30, an item must be a contingency and must not be in the scope of another Topic.

Question 2.3.10 lists several of the types of loss contingencies that are in the scope of another Topic. Many of the items on that list can create a gain contingency as well as a loss contingency. For example, litigation may give rise to a gain contingency either through a favorable court decision or through settlement with the defendant.

Question 6.3.10 What is a gain contingency?

Interpretive response: A gain contingency is 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. [450-30 Glossary]

This definition aligns with the definition of a contingency in Subtopic 450-10, which relates to both gain and loss contingencies. Under these two definitions, the following elements are necessary for a contingency to exist.

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See Question 2.2.10 for additional discussion of these elements.

Examples of gain contingencies include:

- a favorable monetary outcome derived from a lawsuit;
- the nonrefundable recovery of a loss contingency that does not yet qualify for accrual;
- the amount of an insurance recovery in excess of the costs and losses recognized in the financial statements (see Question 6.4.40 for an example); and
- recovery amounts exceeding a recognized environmental remediation loss.

Question 6.3.20 When does the loss recovery model apply vs the gain contingency model?

Interpretive response: The loss recovery model is used to recognize the recovery of costs and losses that have already been incurred. The gain contingency model is used to recognize amounts recovered that exceed costs and losses previously incurred. We use the term 'mixed model' when both models apply to a transaction (such as receipt of insurance proceeds that comprise both the recovery of recognized losses and additional amounts). See section 6.4 for application of the mixed model in the context of business interruption insurance.

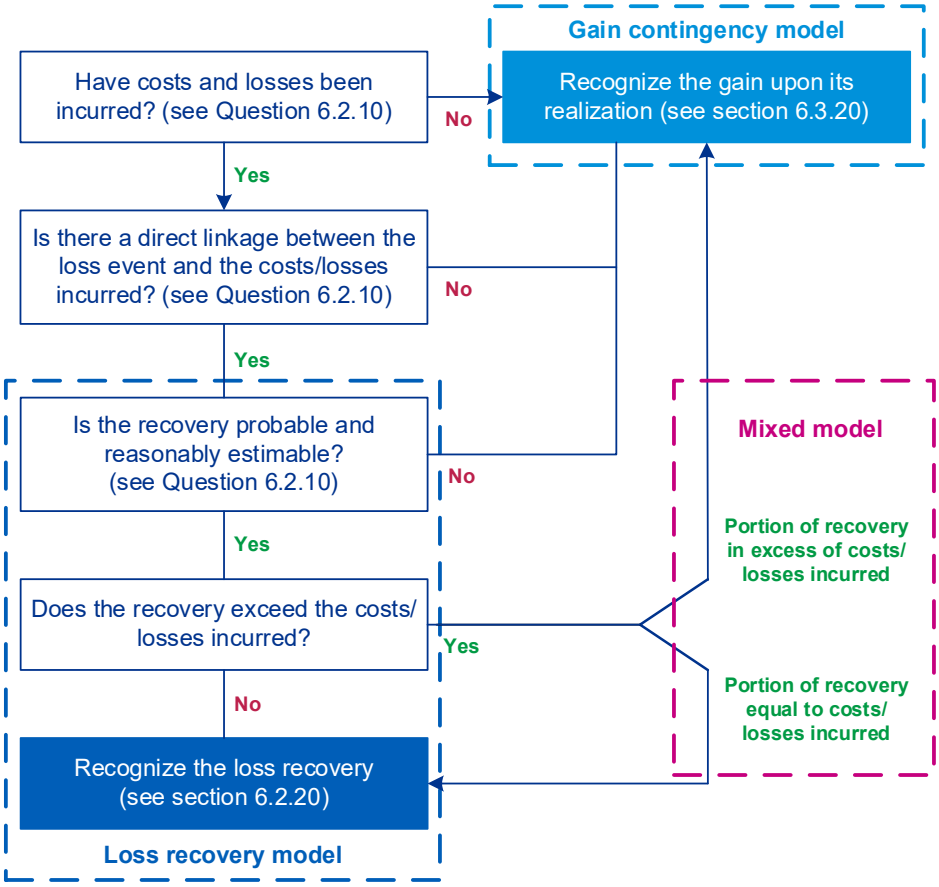
The applicability of each model in the context of loss recoveries is summarized as follows.

- **Loss recovery model.** This model applies when the amount being recovered relates to costs and losses that have already been incurred. For this model to apply, there must be a direct linkage between the loss (or costs incurred), the loss event and the recovery. For example, insurance proceeds must have a direct linkage to a recognized loss. The loss recovery model is discussed in section 6.2.
- **Gain contingency model.** This model applies when:
  - a recovery exceeds the costs and losses incurred as a result of the loss event;
  - the losses or costs subject to recovery have not yet been incurred/recognized; or
  - there is no clear evidence of the linkage between costs and losses incurred, the loss event and the recovery amount.

Gain contingencies can also arise in other contexts that do not involve the recovery of losses.

The following diagram depicts the circumstances under which the loss recovery, gain contingency or mixed model applies to a transaction.

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The mixed model is illustrated in Example 6.3.20.

Question 6.3.30 Can government grants be accounted for under the gain contingency model?#

Interpretive response:

Before adoption of ASU 2025-10

Yes, provided there is no other applicable guidance.

Prior to ASU 2025-10, US GAAP provides limited guidance on accounting for government grants. An entity first applies any guidance explicitly applicable to the grant, such as the guidance on agricultural subsidies in Subtopic 905-605 or the guidance on grants explicitly applicable to not-for-profit entities in Subtopic 958-605. If no explicit accounting guidance exists, the entity next determines if the revenue guidance in Topic 606 applies (see Question 2.3.100 in KPMG Handbook, Revenue recognition).

When a government grant is not subject to explicitly applicable guidance and is not in the scope of Topic 606, the entity elects an accounting policy to account for the grant using one of the following models:

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- the grant model in International Accounting Standard (IAS) 20, Accounting for Government Grants and Disclosure of Government Assistance, under IFRS Accounting Standards;
- the contribution model in Subtopic 958-605;
- the revenue model in Topic 606; or
- the gain contingency model in Subtopic 450-30.

The accounting model applied may affect the government grant's presentation, timing of recognition and disclosures. When using the gain contingency model in Subtopic 450-30, an entity does not recognize income related to a grant until its realization and is not subject to the disclosure requirements for government assistance in Topic 832. Regardless of the accounting model selected, we do not believe government grants should be presented as revenue from contracts with customers.

For more guidance on accounting for, presenting and disclosing government grants, see Question 2.3.100 in KPMG Handbook, Revenue recognition, Question 4.5.30 in KPMG Handbook, Financial statement presentation, and KPMG Issues In-Depth, Government assistance disclosures.

After adoption of ASU 2025-10

No, for government grants in the scope of Topic 832 upon adoption of ASU 2025-10. In December 2025 the FASB issued ASU 2025-10 on the accounting for government grants received by business entities. The ASU is effective for annual and interim periods in fiscal years beginning after December 15, 2028 for public business entities and annual and interim periods in fiscal years beginning after December 15, 2029 for all other business entities. Early adoption is permitted.

The ASU amends Topic 832 to define what is considered a government grant and provides recognition, measurement and presentation guidance, while retaining and expanding the existing disclosure requirements. A government grant is defined as a transfer of a monetary or tangible nonmonetary asset, other than an exchange transaction, from a government to a business entity. Under the new accounting model, a government grant is not recognized until both of the following conditions are met: (1) it is probable that the entity will comply with the grant's conditions and that the grant will be received; and (2) the entity meets the specific recognition guidance for a grant related to an asset (i.e. as the related costs are incurred) or a grant related to income (i.e. as the related expenses are incurred).

Upon adoption of the ASU, business entities are required to apply the guidance in Topic 832 to government grants in its scope and therefore would not account for those grants by analogy to the gain contingency model in Subtopic 450-30. However, certain forms of government grants are outside the scope of Topic 832 (e.g. transfers of intangible assets). For transactions that are not in the scope of Topic 832 and are not addressed by other authoritative US GAAP, an entity may need to evaluate the appropriate accounting model based on the specific facts and circumstances.

For more guidance on accounting for, presenting and disclosing government grants, see KPMG Defining Issues, FASB issues ASU on accounting for

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government grants, and Question 2.3.100 in KPMG Handbook, Revenue recognition.

6.3.20 Application of the gain contingency model

Excerpt from ASC 450-30

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.

Under the gain contingency model, a gain contingency is not recognized before its realization. This contrasts with the loss recovery model, which is based on probability of occurrence and other factors (see section 6.2.20). [450-30-25-1]

Question 6.3.40 When does realization of a gain contingency occur?

Interpretive response: We believe realization of a gain contingency occurs when the gain is realized or realizable. The terms 'realized' and 'realizable' historically had been defined in FASB Concepts Statement No. 5, Recognition and Measurement in Financial Statements of Business Enterprises (CON 5). CON 5 was superseded and the remaining Concept Statements no longer define these terms.

Under the superseded historical definitions, a gain is: [former CON 5.83(a)]

- **realized** when cash or a claim to cash is received; and
- "**realizable** when related assets received or held are readily convertible to known amounts of cash or claims to cash."

We believe realization cannot occur until the underlying contingency is resolved. Further, there cannot be a contingency attached to the items received. For example, cash cannot be subject to refund, or realization cannot be subject to the entity's future performance or events outside the entity's control.

Typically, once a contingency is resolved, an entity immediately obtains a claim to cash – i.e. a receivable is recognized until cash is received. We believe collectibility should be considered when assessing recognition of the gain and corresponding receivable.

An example of the resolution of a contingency is the execution of a binding arbitration agreement that is not subject to additional appellate steps (see Example 6.3.10).

Questions 6.3.60, 6.3.70 and 6.4.30 discuss realization in the context of, respectively, a court ruling, an insurance subrogation participation clause and a structured settlement.

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Example 6.3.10 Gain contingency recognized when a binding arbitration agreement exists

ABC Corp executes a binding arbitration settlement agreement before the reporting date. The terms of the agreement state that payment of the amount specified in the agreement is due as of the award date. However, the cash payment is not received until after the reporting date. The arbitration settlement cannot be appealed.

Given the nature of the contingency not involving the recovery of costs, ABC concludes the gain contingency model is applicable.

Because the execution of the binding arbitration agreement is not subject to additional appellate steps, ABC determines that all contingencies have been resolved at settlement. ABC has been awarded a claim to cash and therefore the gain is realized at the reporting date. Cash does not need to be received for a gain to be realized, as long as all contingencies related to the claim are resolved (see Question 6.3.40).

Further, receipt of payment after the reporting date is strong evidence of the collectibility of the full amount of the receivable (i.e. the claim to cash).

For these reasons, ABC recognizes the gain at the reporting date.

Question 6.3.50 How does Topic 855 on subsequent events apply to the gain contingency model?

Background: Subsequent events are events or transactions that occur after the reporting date but before the financial statements are issued or available to be issued (i.e. the subsequent events period). Subsequent events are categorized into two broad types: recognized events (Type 1) and nonrecognized events (Type 2). See section 3.6. [855-20 Glossary, 855-10-25-1]

Interpretive response: Subsequent events rarely result in the recognition of gain contingencies at the reporting date under the gain contingency model. This is because Subtopic 450-30 does not permit a gain contingency to be recognized until realization, which we believe is a definitive concept that requires the underlying contingency to be completely resolved (see Question 6.3.40). [855-10-15-5(c)]

Therefore, if a gain contingency was probable at the reporting date and is settled during the subsequent events period, the settlement is a nonrecognized subsequent event that must be disclosed under both Subtopic 450-30 and Topic 855 (see section 6.5.40). The gain contingency is recognized in the period of its realization (i.e. the period it is settled).

Example 6.3.20 Insurance recovery settled after the reporting date and mixed model applies

ABC Corp suffers equipment damage due to a natural disaster. The following facts are relevant.

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- **December 1, Year 1:** ABC's equipment is destroyed by a hurricane. The equipment has a net book value of $1,500 and an estimated replacement cost of $1,600. ABC files a claim with its insurer shortly thereafter.
- **December 31, Year 1 (reporting date):** Based on discussions with the insurer, ABC concludes it is probable insurance recoveries will be at least $1,600.
- **February 1, Year 2:** ABC receives payment of $1,600 from the insurer as final settlement for the claim.
- **March 15, Year 2:** December 31, Year 1 financial statements are issued.

In its Year 1 financial statements, ABC:

- writes off the net book value of the destroyed equipment of $1,500 as a loss under Subtopic 610-30;
- applies the loss recovery model to the portion of the expected insurance proceeds up to the amount of the recognized loss and recognizes an asset of $1,500 for the probable recovery of the loss (under the probability assessment, settlement of the claim is not necessary to recognize the recovery);
- applies the gain contingency model to the $100 excess of the probable recovery of $1,600 over the costs and losses incurred of $1,500 and does not recognize a gain for the excess because realization has not occurred at the reporting date; and
- discloses as a nonrecognized subsequent event the $100 gain to be recognized upon settlement in Year 2.

In summary, no net gain or loss is recognized in Year 1. Income statement presentation of the loss and recovery is discussed in section 6.5.20.

In its Year 2 financial statements, when the settlement is reached, ABC recognizes the remaining recovery of $100 because the insurance proceeds in excess of the loss is a gain contingency recognized upon its realization.

Question 6.3.60 Is a gain contingency associated with litigation resolved when either the litigation is settled or the court enters a ruling?

Interpretive response: It depends. An entity must determine whether any further uncertainty exists with the settlement or court ruling. Typically, if a court enters a ruling in favor of the entity, uncertainty will continue to exist unless and until all appeals by either party have been exhausted (or not pursued). Further, while a settlement agreement between the litigants is not subject to appeal, uncertainty exists if that agreement needs approval from another body – e.g. the other litigant's board of directors, a government agency, a regulatory body.

There also may be uncertainties as to the amount the entity is entitled to once litigation is settled or adjudicated. This could occur, for example, if the entity is one of multiple plaintiffs and the settlement document does not identify how much of the total settlement amount is due to each plaintiff. If there could be a

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dispute as to how the settlement amount will be divided among the plaintiffs, a contingency continues to exist.

As the discussion above indicates, whether a contingency has been resolved depends on the facts and circumstances.

Question 6.3.70 Does a subrogation participation clause prevent realization under the gain contingency model?

Background: A subrogation participation clause is a legal provision in an insurance contract that ensures insurers can pursue legal claims against liable parties to hold them accountable for damages. The typical subrogation participation clause obligates an entity to participate in future subrogation (recovery) actions undertaken by its insurer. This often includes making employees available for interviews, procuring and furnishing necessary documents, and attending depositions and court proceedings as needed. If litigation is necessary to resolve an insurer's claims with third parties, the entity often agrees to be a plaintiff in that litigation.

Interpretive response: It depends.

We believe the existence of the subrogation participation clause in a settlement agreement does not preclude realization of a contingent gain if:

- there is no specific action that will occur should the entity not participate in such activities; and
- there is no impact on the settlement amount from the subrogation actions (e.g. should the insurer not prevail in litigation, the entity's settlement amount will not decrease).

6.4 Business interruption insurance recoveries

6.4.10 Overview

Excerpt from ASC 220-30

05-1 This Subtopic provides presentation and disclosure guidance for **business interruption insurance**.

05-2 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).

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> Overall Guidance

15-1 This Subtopic follows the same Scope and Scope Exceptions as outlined in the Overall Subtopic, see Section 220-10-15.

20 Glossary

Business Interruption Insurance

Insurance 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 the damaged property.

A business interruption is the suspension of business operations (i.e. the loss of prospective earnings and profits) due to the loss of, or inability to use, property and equipment that results from a defined cause of loss, such as weather damage, fire or explosion.

Business interruption insurance differs from other types of insurance because it is designed to protect the *prospective* earnings of an entity. It generally provides for reimbursement of the following costs and losses during the period of disruption: [220-30-05-02, 220-30 Glossary]

- gross margin lost or not earned;
- fixed costs related to that lost gross margin – e.g. rent on equipment that cannot be used; and
- other expenses incurred to reduce the loss – e.g. rent on a temporary facility.

Subtopic 220-30 covers the presentation and disclosure of business interruption insurance but does not address when to recognize insurance recoveries for business interruption losses (see section 6.5). When recoveries from business interruption insurance involve both reimbursement of incurred costs and losses and of lost margin, the mixed model applies (i.e. both the loss recovery model and gain contingency model apply) (see Question 6.4.10).

6.4.20 Recognition and measurement

Question 6.4.10 When are insurance recoveries for business interruption recognized?

Interpretive response: Insurance recoveries related to business interruption are often recognized under a mixed model that combines the loss recovery model (see section 6.2) and the gain contingency model (see section 6.3).

Under the loss recovery model, recoveries directly linked to costs and losses incurred (including fixed costs) are recognized when those recoveries are probable and reasonably estimable (see Question 6.2.10).

If an anticipated recovery is not directly linked to costs and losses incurred (e.g. lost margin), the gain contingency model applies. This means the anticipated

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recovery is not recognized until its realization – which includes resolution of all contingencies (see section 6.3.20).

When the insurance recovery combines different types of coverage (e.g. property damage and business interruption) and is paid as a lump sum, judgment may be required to determine the amount attributable to each type of coverage.

Example 6.4.10 Insurance recovery related to business interruption

On December 1, Year 1, ABC Corp sustains a significant gas explosion at its distribution center that will affect its operations for the next three months (the interruption period). ABC has business interruption insurance and, since the date of the explosion, has been in negotiations with the insurer about its business interruption claim.

To determine whether to recognize any amount of its anticipated insurance recovery in Year 1, ABC applies the following methodology.

Determine which costs and losses are directly linked to the insured event

ABC determines that the gas explosion is a covered event under the policy. Coverage starts from the date of the covered event until the property is repaired or replaced with a maximum period of 360 days. ABC is entitled to reimbursement for the following costs and losses during the interruption period (i.e. the insured costs and losses):

- lost margin – i.e. the income the business would have earned based on historical performance;
- fixed operating expenses incurred – e.g. rent, utilities, insurance premiums;
- payroll – i.e. compensation for employee wages to retain staff;
- relocation costs, if the business must temporarily move due to physical damage; and
- extra expenses – e.g. additional costs incurred to minimize the business interruption, such as renting temporary equipment or facilities.

Determine which insured costs and losses have been incurred at the reporting date

ABC determines the amount of fixed operating expenses, payroll, relocation costs and extra expenses incurred during the period December 1, Year 1 to December 31, Year 1.

The amount of lost margin is disregarded under the loss recovery model because it is not considered 'incurred' – i.e. the corresponding lost revenue and unspent variable costs are not recognized costs or losses.

Determine whether recovery of the insured costs and losses is probable and reasonably estimable at the reporting date

ABC next determines if recovery of insured costs and losses incurred at the reporting date is probable and reasonably estimable. For example, ABC

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considers the applicable policy terms, its history of successful recovery under those terms for similar claims, the applicable deductible and the creditworthiness of the insurer.

The insurance recovery recognized in Year 1 is limited to the amount of insured costs incurred that are probable of recovery and reasonably estimable at the reporting date. Under the loss recovery model, recoveries for costs to be incurred in Year 2 cannot be recognized in Year 1 because the costs have not yet been incurred at the reporting date, even though recovery may be probable at the reporting date or eventually realized during the subsequent event period.

Determine the accounting for the lost margin

Recovery of lost margin during the interruption period (Year 1 and Year 2) is accounted for under the gain contingency model. As a result, it cannot be recognized until its realization.

Example 6.4.20 illustrates a situation where the recovery of the margin lost in Year 1 is realized in Year 2. The recovery is recognized as a gain in Year 2.

Example 6.4.30 illustrates a situation where the recovery of the margin lost in Year 1 and 2 is realized in full in Year 1, i.e. before the end of the interruption period. The recovery is recognized as a gain in full in Year 1.

Question 6.4.20 Is settlement of a business interruption insurance claim a recognized subsequent event?

Interpretive response: It depends on the nature of the recovery and which recognition model applies.

Settlement during the subsequent events period of a business interruption insurance claim for…	Model	Is this a recognized or nonrecognized subsequent event?
Costs and losses incurred on or before the reporting date	Loss recovery	Could be a recognized subsequent event (see Question 6.2.70)
Lost margin	Gain contingency	Nonrecognized subsequent event (see Question 6.3.40)

If a settlement is a nonrecognized subsequent event, the entity still provides the disclosures required by Topic 855. [855-10-50-2]

Lastly, Topic 855 does not affect when operating costs are recognized. Operating costs incurred in the period business is interrupted are recognized as incurred and cannot be deferred.

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Example 6.4.20 Business interruption claim settled after the reporting date and mixed model applies

On January 15, Year 2, before issuing its December 31, Year 1 financial statements, ABC Corp receives payment of $100 million from its insurer as final settlement for a business interruption claim – $60 million for fixed costs incurred in Year 1 and $40 million for lost margin in Year 1. There is no deductible.

Settlement of the claim is a subsequent event that provides additional evidence that recovery of fixed costs incurred in Year 1 is probable as of December 31, Year 1 (i.e. a recognized subsequent event). As a result, ABC recognizes a recovery of $60 million under the loss recovery model in Year 1.

In contrast, the gain of $40 million for the margin lost in Year 1 cannot be recognized until its realization (i.e. a nonrecognized subsequent event). As a result, recognition of the gain is delayed under the gain contingency model until the claim is settled in Year 2.

Question 6.4.30 When is a recovery related to a structured insurance settlement recognized?

Background: Settlement agreements with a business interruption insurer do not always result in a one-time payment; some are 'structured' settlement agreements. In the context of business interruption insurance, a structured settlement can require payments over a period that aligns with the insured entity's projected business recovery timeline and expenses.

Interpretive response: An entity recognizes an anticipated recovery in excess of incurred costs and losses (i.e. a contingent gain) upon its realization (see Question 6.3.40). We believe a structured settlement represents realization of the gain for accounting purposes as long as the settlement does not contain future performance or other conditions. Therefore, absent such conditions, the entity recognizes the full insurance recovery (i.e. including any contingent gain) at the time it enters into the structured settlement.

Examples of future performance conditions are when payments under the settlement terms require the entity to continue to pay insurance premiums or incur the future expenses the entity is being compensated for. In those cases, we believe the entity should not recognize any contingent gain at the time it enters into the structured settlement. Instead, it recognizes the contingent gain when it pays the insurance premiums or incurs the eligible expenses (i.e. satisfies the future performance condition).

Assessing effects of future performance condition on loss recovery

The existence of a future performance condition may also delay the recognition of the portion of the settlement that amounts to a loss recovery. This would be the case if it affects the entity's evaluation of whether a recovery of the incurred costs and losses is probable and reasonably estimable.

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Determining the amount to recognize

Regardless of whether an entity applies the loss recovery or gain contingency model, it has to determine:

- the amount it is entitled to receive during the structured settlement period; and
- whether that amount is actually recoverable.

The insurer's creditworthiness is an important factor in determining whether the amount an entity will receive over the settlement term is actually recoverable.

Question 6.4.40 Is the recognition of an insurance settlement for business interruption deferred until all losses are incurred?

Background: An entity experiences a business interruption due to a natural disaster. The entity receives payment from its insurer as final settlement for its business interruption loss claim. Such claim and settlement contemplate but do not depend on incurred losses and projected (future) losses.

Interpretive response: Generally, no. Recoveries of costs and losses that have not yet been incurred are recognized under the gain contingency model upon realization of the gain (see Question 6.4.10).

Unless the settlement depends on incurring actual future costs, we believe that the settlement is evidence of realization and triggers recognition of the gain. Deferring recognition of the gain to future periods (i.e. matching) in that case is not appropriate.

Example 6.4.30 Insurance settlement before all losses are incurred

In January Year 1, ABC Corp experiences an explosion at a production facility that causes extensive property damage and the inability to manufacture products. ABC anticipates lost sales, resulting in the loss of operating margin and unrecovered fixed costs through the insurable period of 18 months.

ABC has insurance that provides indemnity for losses due to business interruption and property damage. The policy limit is $500 million for all costs, and the policy does not contain separate limits for property damage and business interruption.

Settlement details

In October Year 1, ABC and its insurers execute a settlement agreement for net proceeds of $430 million to be paid to ABC. In November Year 1, the insurer makes final payments to a loss proceeds account with ABC's term credit lender (Lender). The proceeds are released to ABC only after ABC meets certain documentation requirements.

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As of December 31, Year 1, ABC has received $300 million of the total settlement of $430 million, having provided sufficient evidence to Lender that the $300 million represents business interruption proceeds to which ABC has full, immediate right of use. The remaining $130 million represents property damage proceeds and will be released to ABC once it provides evidence of actual incurred reconstruction costs. It is expected that ABC will receive these proceeds in due course of its reconstruction efforts. In the event the allocation of funds for property damage are not used to rebuild the production facility or evidentiary requirements are not met, Lender will apply these excess funds against ABC's outstanding debt balance.

As of December 31, Year 1, the damaged facility has not been repaired or replaced. The settlement amount exceeds all costs and losses incurred through the date of settlement and the reporting date. This settlement is not contingent on any future performance of ABC.

Analysis

Under Subtopic 450-30, a gain contingency is not recognized in the financial statements until its realization. In this instance, all contingencies related to the insurance claim have been resolved upon execution of the settlement agreement and the insurers' payment of $430 million to the loss proceeds account. Therefore, this amount is recognized in full in Year 1.

The provisions of the term credit agreement do not affect the realization of the insurance settlement because the full proceeds of the settlement will benefit ABC, even if ABC does not provide evidence of the reconstruction costs to Lender.

6.5 Presentation and disclosure

6.5.10 Balance sheet

Because gain contingencies are only recognized upon realization, which is often evidenced through the receipt of cash, they typically do not give rise to a noncash asset (i.e. a receivable). However, the recognition of an asset in the case of loss recoveries is more common, given these recoveries could be recognized prior to realization depending on the facts and circumstances. Similar to loss contingencies, the balance sheet presentation of gain contingencies and loss recoveries raises the following questions about any corresponding asset recognized.

- Is it classified as current or noncurrent on a classified balance sheet?
- Can it be offset against a related contingent liability?

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Question 6.5.10 How are assets recognized under the gain contingency or loss recovery model presented on a classified balance sheet?

Interpretive response: Entities apply Topic 210 to determine the appropriate balance sheet classification of assets recognized under the gain contingency or loss recovery model (e.g. insurance recoveries). In general, current assets are assets that are reasonably expected to be realized in cash or sold or consumed within one year or the entity's operating cycle if longer. Amounts that are not current assets are presented as noncurrent. Accordingly, classification as current or noncurrent is generally based on the expected period of settlement. [210-10-45-1]

For additional information about balance sheet classification, see section 3.3 of KPMG Handbook, Financial statement presentation.

Question 6.5.20 Can a liability be presented net of a related insurance recovery?

Interpretive response: Generally, no. The SEC staff has stated that the right of setoff for an insurance recovery and related liability is usually rare. Except in those rare circumstances where the right of setoff exists, an entity reports the appropriately recognized contingent liability and insurance recovery asset on a gross basis. [2002 AICPA Conf]

When a third-party actuary develops an estimate of a liability, it often reports the liability net of estimated insurance recoveries. Therefore, an entity should request that the actuary report the gross amounts for the asset and liability.

For example, assume an entity:

- incurs a liability to an unrelated third party for damage to the third party's property; and
- determines an asset should be recognized for the insurance recovery related to the damage (in part because recovery from its insurance carrier is probable).

Absent further action, the asset for the insurance recovery cannot be offset against the liability to the third party because one of the conditions for the right of setoff is that the reporting party has the right to set off the amount owed *to* the third party with the amount owed *by* the insurer. [220-20-45-1(b)]

For additional information about balance sheet offsetting, see section 3.4 of KPMG Handbook, Financial statement presentation.

6.5.20 Income statement

The presentation of gain contingencies and loss recoveries in the income statement raises the following questions.

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- Where (e.g. caption, subtotal) is it reported?
- Is it separately reported from other income statement items?
- Can it be netted with the corresponding loss?

Question 6.5.30 How are gain contingencies and loss recoveries presented in the income statement?

Interpretive response: The presentation of gain contingencies and loss recoveries in the income statement requires judgment and depends on the nature of the contingencies. All relevant facts and circumstances should be considered.

Subtopic 410-30 (environmental obligations) requires environmental claims recoveries to be presented in the same captions as the related costs. This guidance is often used by analogy to support a presentation of other types of loss recoveries, such as insurance recoveries, as a reduction of the corresponding costs. [410-30-45-4]

Specific considerations related to the income statement presentation of involuntary conversions of nonmonetary assets and business interruption insurance are discussed in Questions 6.5.40 and 6.5.50, respectively.

Further, if a gain contingency or an insurance recovery is unusual or infrequent under Subtopic 220-20, it is presented as a separate component of income from continuing operations. See section 4.4 of KPMG Handbook, Financial statement presentation, for guidance on the definition and presentation of unusual or infrequently occurring items.

Question 6.5.40 How are gains and losses from involuntary conversions presented in the income statement?

Excerpt from ASC 610-30

45-1 Gain or loss resulting from an involuntary conversion of a nonmonetary asset to monetary assets shall be classified in accordance with the provisions of Subtopic 220-20.

Interpretive response: Subtopic 610-30 provides that recoveries and losses from involuntary conversions of nonmonetary assets to monetary assets are presented net as a gain or loss. For example, the loss from writing off the carrying amount of property destroyed in a natural disaster is presented net of any related insurance proceeds recognized in the period of the loss. [610-30-45-1]

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Question 6.5.50 How are the proceeds from business interruption insurance presented in the income statement?

Excerpt from ASC 220-30

45-1 An entity may 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).

Interpretive response: Subtopic 220-30 provides flexibility around the income statement classification of business interruption insurance, as long as the presentation does not contradict existing US GAAP. [220-30-45-1]

We do not believe proceeds from business interruption insurance should be presented as revenue. In our experience, entities typically include these proceeds in operating income when such a subtotal is presented. Examples of income statement display include presenting:

- proceeds representing recoveries of costs and losses incurred as:
  - a separate caption;
  - a reduction of total operating expenses; or
  - a reduction of the corresponding expense line items with disclosure of the amounts received (see Question 4.3.90 of KPMG Handbook, Financial statement presentation);
- proceeds in excess of costs and losses incurred as a separate caption from operating expenses; or
- the total amount of proceeds as a separate caption from operating expenses.

6.5.30 Statement of cash flows

Question 6.5.60 How are cash flows from the settlement of insurance claims classified?

Excerpt from ASC 230-10

> Classification

• > Proceeds from the Settlement of Insurance Claims

45-21B Cash 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). For insurance proceeds that are received in a lump-sum settlement, an entity shall determine

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the classification on the basis of the nature of each loss included in the settlement.

Interpretive response: The classification of the proceeds from the settlement of property, casualty and liability insurance claims depends on the nature of the loss. We believe the following guidance should be applied.

Insurance proceeds received for	Classification as cash inflows from
Damaged property, plant and equipment that is owned or under a capital/finance lease for the lessee	*Investing* activities
Business interruption, inventory or minor repairs of property and equipment	*Operating* activities
More than one loss, as a lump sum	• Allocation of insurance proceeds to each underlying loss; and • Each allocated amount is classified based on the nature of the associated loss

For further guidance on the cash flow statement presentation of insurance recoveries, see chapter 17 of KPMG Handbook, Statement of cash flows.

6.5.40 Disclosures

There is limited guidance in US GAAP addressing disclosures for gain contingencies and loss recoveries. Over the years, the SEC has expressed its views on what disclosures may be appropriate in those circumstances.

Question 6.5.70 What disclosures should be considered for gain contingencies?

Excerpt from ASC 450-30

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.

Interpretive response: Subtopic 450-30-50 has limited disclosure requirements for gain contingencies. It simply requires that 'adequate disclosure' be made for contingencies that might result in a gain, leaving an entity to determine what constitutes adequate disclosure. [450-30-50-1]

Depending on facts and circumstances, we believe an entity should consider timely disclosure of the following:

- the nature of the contingency (including a description of the facts leading to the contingency);

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- the parties involved;
- any remaining uncertainties and when resolution is expected;
- the amount of gain that has or may be realized, and
- the line item(s) in the statement of operations in which any realized gain is classified.

However, Section 450-30-50 prohibits disclosures that would mislead financial statement users about the likelihood of a gain being realized. Therefore, caution should be exercised when disclosing the expected amounts or timing for realization of unrealized gain contingencies. [450-30-50-1]

Disclosures about a gain contingency should be updated as additional information becomes available, including quantitative information as a matter gets closer to resolution.

Question 6.5.80 What disclosures are required for loss recoveries, including business interruption insurance recoveries?

Excerpt from ASC 220-30

50-1 The following information shall be disclosed in the notes to financial statements in the period(s) in which **business interruption insurance recoveries** are recognized:

a. The nature of the event resulting in business interruption losses
b. The aggregate amount of business interruption insurance recoveries recognized during the period and the line item(s) in the statement of operations in which those recoveries are classified.

Interpretive response: Paragraph 220-30-50-1 (excerpted directly above) lists the required disclosures for business interruption insurance recoveries in the period recognized. We believe these disclosures are equally relevant to, and should therefore be provided for, other types of loss recoveries. These disclosures are in addition to any disclosures required by other Subtopics for an entity's specific facts and circumstances – e.g. disclosures required for the costs and losses incurred under the insured event.

Further, the SEC staff expects registrants to disclose the following about third-party recoveries: [2011 AICPA Conf, SAB Topic 5.Y (fn 49)]

- whether loss estimates are presented gross or net of the recoveries;
- the accounting policy for recognizing the recoveries;
- the existence and nature of uncertainties related to the recoveries;
- the classification of recoveries in the income statement; and
- when the counterparty is asserting that it is not liable for the recovery but the registrant has overcome the rebuttable presumption that a claim for recovery cannot be recognized (see Question 6.2.40):

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— the amount of recognized recoveries that are being contested; and
— the reasons for concluding that the amounts are probable of recovery.

We believe that these disclosures are also relevant for nonregistrants.

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7. Guarantees and product warranties

Detailed contents

Item significantly updated in this edition: #

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Question 7.2.10 What types of guarantee contracts are in the scope of Topic 460?

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Question 7.2.30 How does a guarantor assess whether an underlying is related to an asset, liability or equity security of the guaranteed party?

Question 7.2.40 Does whether a guarantee of debt is in the scope of Topic 460 depend on whether the guaranteed party is the creditor or debtor?

Question 7.2.50 Does gross (vs net) settlement mean the same thing when evaluating '*of the* guaranteed party' as it does under Topic 815?

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Question 7.2.100 Is a guarantee that accompanies the sale of real estate in Topic 460's scope?

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Example

Example 7.7.10 Product warranty disclosures

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7.1 How the standard works

Topic 460 establishes accounting and disclosure requirements for the guarantor (obligor) of guarantees, including product warranties. It provides separate scoping, recognition and measurement guidance for product warranties as compared to other guarantees. Some of its disclosure requirements apply to both product warranties and guarantees, and others incrementally apply to product warranties.

References to 'guarantees' in this chapter are to guarantees other than product warranties, and separate discussion is provided for these guarantees and product warranties.

	Scope, recognition and measurement	Disclosures
Guarantees (other than product warranties)	Sections 7.2 through 7.5	Section 7.7
Product warranties	Section 7.6	

Guarantees

Some guarantees in Topic 460's scope are subject to all of its guidance while others are subject only to its disclosure guidance.

Guarantee contracts in Topic 460's scope	
• Financial guarantees • Performance guarantees	• Indemnifications • Indirect guarantees of indebtedness of others
Guarantee contracts excluded from Topic 460's entire scope	
• Guarantees or indemnifications that are excluded from Topic 450's scope, such as employment-related guarantees • Guarantees or indemnifications in the scope of certain other Topics/Subtopics	• Guarantees or indemnifications whose existence prevents sale accounting • Guarantees or indemnifications of an entity's own future performance
Guarantee contracts excluded from Topic 460's general recognition and measurement (but not disclosure) guidance	
• Certain guarantees issued between entities under common control	• Guarantees in the scope of certain other Topics/Subtopics

A guarantor is required to recognize a liability for both the noncontingent and contingent components of guarantees. How each component is measured and how those measurements interact depends on whether the guarantee is also in the scope of either Subtopic 326-20 or Topic 480 and, if not, on the guarantor's accounting policy election.

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Product warranties

Product warranties are guarantees for which the underlying is related to the performance (regarding function, not price) of nonfinancial assets that are owned by the guaranteed party. The obligation may be incurred in connection with the sale of goods or services and, if so, it may require further performance by the seller after the sale has taken place.

Measurement of the guarantee obligation for a product warranty depends on whether it is a service-type (Topics 605 and 606 apply) or an assurance-type warranty (Subtopic 450-20 applies, with incremental guidance provided in Topic 460).

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7.2 Guarantees: Scope

7.2.10 Overview

Excerpt from ASC 460-10

General

05-1 The Guarantees Topic establishes the accounting and disclosure requirements to be met by a guarantor for certain guarantees issued and outstanding. This Topic contains only the Overall Subtopic. The guidance in this Subtopic is presented in the following two Subsections:

a. General
b. Product **Warranties**

05-2 The General Subsections address the recognition of a liability by a guarantor at the inception of a guarantee for the obligations the guarantor has undertaken in issuing that guarantee, and require certain disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under guarantees.

10-1 The objective of the Guarantees Topic is to achieve transparency in a guarantor's financial reporting about the obligations and risks arising from issuing guarantees in the following two ways:

a. To provide informative disclosures about the nature and amount of guarantees in the financial statements of guarantors
b. To help ensure comparability of financial reporting for guarantees issued with a separately identified premium and guarantees issued without a separately identified premium by requiring recognition of a liability for the obligation incurred by a guarantor in issuing a guarantee.

Topic 460 applies to all entities that are guarantors of contracts in the Topic's scope. Its objective is to achieve transparency in a guarantor's financial reporting about the obligations and risks arising from issuing guarantees. [460-10-10-1, 15-2]

This objective is achieved by requiring a guarantor to: [460-10-10-1]

- recognize a liability for certain guarantee obligations regardless of whether the guarantees are issued with – or without – a separately identified premium; and
- provide informative disclosures about the nature and amount of certain guarantees.

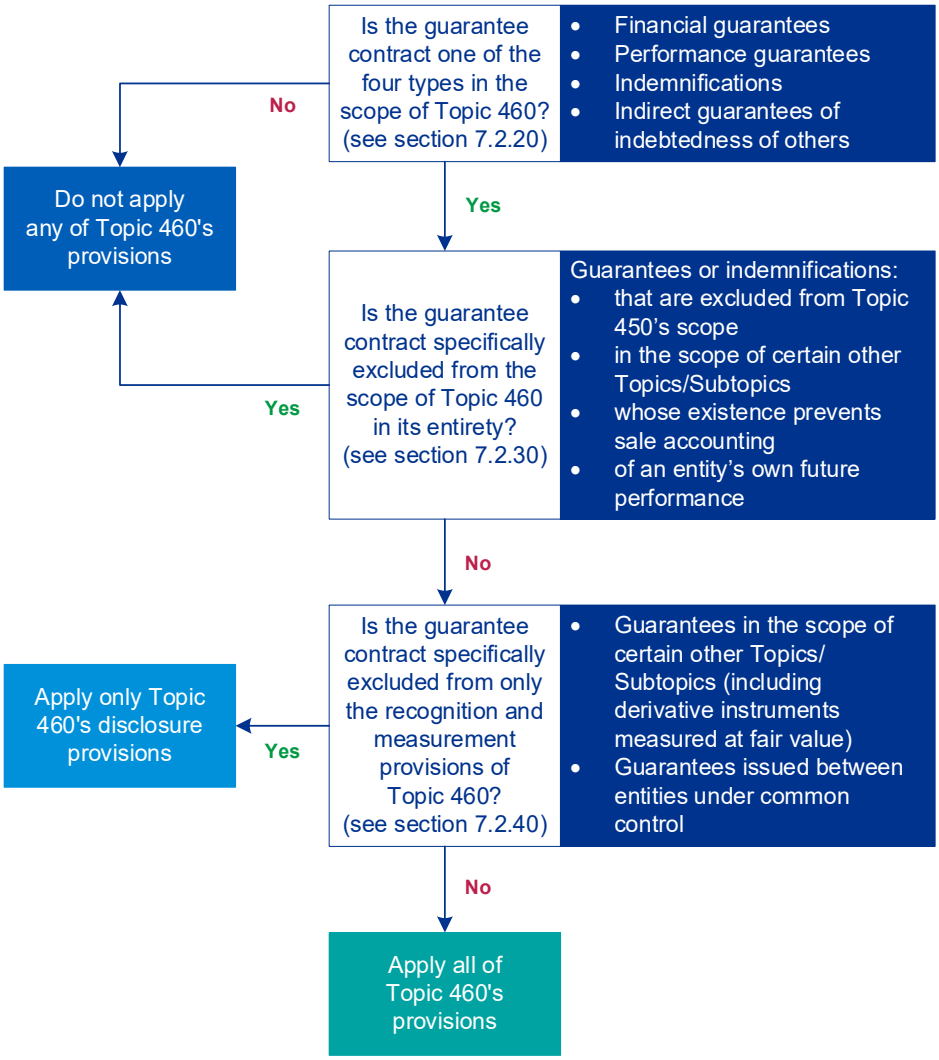
Topic 460 provides separate scoping, recognition and measurement guidance for product warranties as compared to guarantees. This section addresses scoping for guarantees and section 7.6 addresses scoping for product warranties.

Four types of guarantee contracts are in the scope of Topic 460. However, Topic 460 excludes from its entire scope certain guarantees that would otherwise be considered within one of these types. Further, it excludes certain

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guarantees from its recognition and measurement provisions and, as a result, those guarantees are only subject to its disclosure requirements.

This scoping is summarized in the following diagram.



7.2.20 Guarantee contracts in the scope of Topic 460

Excerpt from ASC 460-10

General Note for Financial Instruments

Some of the items subject to the guidance in this Subtopic are **financial instruments**. For guidance on matters related broadly to all financial instruments, (including the fair value option, accounting for registration payment arrangements, and broad financial instrument disclosure

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requirements), see Topic 825. See Section 825-10-15 for guidance on the scope of the Financial Instruments Topic.

General

> Overall Guidance

15-1 The General Subsection of this Section establishes the pervasive scope for the Guarantees Topic, with specific exceptions noted in the other Subsections of this Section.

> Entities

15-2 The guidance in the Guarantees Topic applies to all entities.

> Transactions

• > Transactions That Are within the Scope of This Topic

15-4 Except as provided in paragraph 460-10-15-7, the provisions of this Topic apply to the following types of guarantee contracts:

a. Contracts that contingently require a guarantor to make payments (as described in the following paragraph) to a guaranteed party based on changes in an **underlying** that is related to an asset, a liability, or an equity security of the guaranteed party. For related implementation guidance, see paragraph 460-10-55-2.
b. Contracts that contingently require a guarantor to make payments (as described in the following paragraph) to a guaranteed party based on another entity's failure to perform under an obligating agreement (performance guarantees). For related implementation guidance, see paragraph 460-10-55-12.
c. Indemnification agreements (contracts) that contingently require an indemnifying party (guarantor) to make payments to an indemnified party (guaranteed party) based on changes in an underlying that is related to an asset, a liability, or an equity security of the indemnified party.
d. **Indirect guarantees of the indebtedness** of others, even though the payment to the guaranteed party may not be based on changes in an underlying that is related to an asset, a liability, or an equity security of the guaranteed party.

15-5 Payments by a guarantor (referred to in the preceding paragraph) could be either in cash, financial instruments, other assets, shares of its stock, or provision of services. Further, a guarantor's payments could involve a gross settlement, in which certain assets are concurrently transferred to the guarantor in exchange for the specified consideration (as in the settlement of an exercised put option or other contingent forward contract), or a net settlement. Thus, both financial and nonfinancial contracts are included in the scope of paragraph 460-10-15-4.

15-6 For guarantees of debt, it does not matter whether the guaranteed party is the creditor or the debtor, that is, whether the guarantor is required to pay the creditor or the debtor (who would then have the funds to pay its debt to the creditor). The underlying (that is, the debtor's failure to make scheduled payments or the occurrence of other events of default) could be related to either the creditor's receivable or the debtor's liability.

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Topic 460 applies to four types of guarantee contracts. In addition to describing those four types of guarantees, it also provides examples of certain of those types of guarantees.

Question 7.2.10 What types of guarantee contracts are in the scope of Topic 460?

Interpretive response: Topic 460 applies to four types of guarantee contracts. [460-10-15-4]

Type	Description	Reference
Financial guarantees [460-10-15-4(a)]	Contracts that contingently require a guarantor to make payments to a guaranteed party based on changes in an underlying that is related to an asset, a liability or an equity security of the guaranteed party.	Question 7.2.90
Performance guarantees [460-10-15-4(b)]	Contracts that contingently require a guarantor to make payments to a guaranteed party based on another entity's failure to perform under an obligating agreement.	Question 7.2.150
Indemnification agreements[1] [460-10-15-4(c)]	Contracts that contingently require an indemnifying party (guarantor) to make payments to an indemnified party (guaranteed party) based on changes in an underlying that is related to an asset, a liability or an equity security of the indemnified party.	Question 7.2.160
Indirect guarantees of indebtedness of others [460-10-15-4(d)]	Indirect guarantees of the indebtedness of others, even though the payment to the guaranteed party may not be based on changes in an underlying that is related to an asset, a liability or an equity security of the guaranteed party.	Question 7.2.170

Note:

1. Indemnification agreements function like guarantees. The Board decided to separately list them as a type of guarantee to make clear that they are included in the scope of the guidance for guarantees. [FIN 45.A14]

In general, these guarantees require payment if:

- there are specified changes in an underlying that is related to a guaranteed party's asset, liability or equity security (see Questions 7.2.20 and 7.2.30) – financial guarantees and indemnification agreements; or
- another entity fails to perform under an obligating agreement – performance guarantees and indirect guarantees of the indebtedness of others.

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Question 7.2.20 What is an underlying?

Background: Financial guarantees and indemnification agreements are in Topic 460's scope if they require the guarantor to make payments based on changes in an *underlying* related to an asset, liability or equity security of the guaranteed party.

Interpretive response: An underlying is a variable factor (usually a price or an index) that, along with either a notional amount or a payment provision, determines the cash flows or settlement of a derivative instrument. [460-10-15-4(a), 15-4(c), 460-10 Glossary]

An underlying may be a price or rate of an asset or liability but is not the asset or liability itself. For example, it may be a price or rate associated with a referenced asset or liability that is usually one or some combination of the following: [460-10 Glossary]

- specified interest rate;
- security price;
- commodity price;
- foreign exchange rate;
- index of prices or rates; or
- occurrence or nonoccurrence of a specified event (e.g. a scheduled payment under a contract, an adverse judgment in a lawsuit).

In essence, an underlying is the variable that determines whether the guarantor is required to make a payment.

Question 7.2.30 How does a guarantor assess whether an underlying is related to an asset, liability or equity security of the guaranteed party?

Interpretive response: To determine whether a financial guarantee or indemnification agreement is in Topic 460's scope, a guarantor assesses whether it could be required to make payments based on an underlying related to an asset, liability or equity security *of the* guaranteed party. This condition is met if the guarantee requires gross settlement. [460-10-15-4(a), 15-4(c)]

If the guarantee does not require gross settlement (i.e. it permits or requires net settlement – see Question 7.2.50), an assessment is then needed of whether the underlying is related to an asset, liability or equity security of the guaranteed party. We believe a guarantee meets this condition if the guarantor has a reasonable basis for concluding – at contract inception – that it is probable that the related asset, liability or equity security is of the guaranteed party. The definition of the term 'probable' in Subtopic 450-20 applies in this context (see section 3.3.30). [FIN 45.A8(b)]

This assessment may require significant judgment based on the facts and circumstances about the:

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- nature of the arrangement;
- relationship between the parties to the guarantee; and
- terms of the arrangement.

Question 7.2.120 addresses assessing this condition for a written put option.

Question 7.2.40 Does whether a guarantee of debt is in the scope of Topic 460 depend on whether the guaranteed party is the creditor or debtor?

Interpretive response: No. A guarantee of debt is in the scope of Topic 460 regardless of whether the guaranteed party is the creditor or the debtor. This is because the underlying (i.e. the debtor's failure to make scheduled payments or the occurrence of other events of default) could be related to either the creditor's receivable or the debtor's liability. [460-10-15-6]

Question 7.2.20 discusses the concept of an underlying, and Question 7.2.30 discusses how to evaluate whether an underlying is related to an asset, liability or equity security of the guaranteed party.

Question 7.2.50 Does gross (vs net) settlement mean the same thing when evaluating '*of the* guaranteed party' as it does under Topic 815?

Background: Under Topic 815, a contract meets the net settlement characteristic if its terms provide for net settlement or if it requires gross settlement that is nevertheless essentially equivalent to contractual net settlement. For example, under Topic 815, a contract that requires gross settlement is considered to meet the net settlement characteristic if the asset delivered in the gross settlement is readily convertible to cash. See section 3.5 in KPMG Handbook, Derivatives and hedging. [815-10-15-99]

Interpretive response: No. As discussed in Question 7.2.30, a contract that requires gross settlement is considered to involve an asset, liability or equity security *of the* guaranteed party. Under Topic 460, gross settlement exists if such a settlement is contractually required (i.e. when the contract requires the guarantor's payment to be made in exchange for the guaranteed party's asset, liability or equity security). Such settlement is not considered net settlement even if it is settled with an asset that is readily convertible to cash.

This means that a contract that is considered net settled under Topic 815 because it settles gross with an asset that is readily convertible to cash is considered to settle gross when evaluating whether the underlying is related to an asset, liability or equity security *of the* guaranteed party under Topic 460. In this situation, the contract may be a guarantee contract in Topic 460's scope and also be a derivative in Topic 815's scope. When a guarantee contract is a derivative in the scope of Topic 815, Topic 815's recognition and measurement provisions apply (and not those of Topic 460). Whether the disclosures in Topic

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460 apply to such a contract depends on whether it is a credit derivative. [460-10-55-5]

- **Credit derivative**: Topic 460's disclosures do not apply (i.e. the contract is excluded from all of Topic 460's provisions; see Question 7.2.210).
- **Not a credit derivative**: Topic 460's disclosure requirements still apply (i.e. the contract is only excluded from Topic 460's recognition and measurement provisions; see Question 7.2.250).

Question 7.2.60 Must cash payments be made under a guarantee contract for it to be in the scope of Topic 460?

Interpretive response: No. The payment the guarantor must make is not limited to a payment in cash; payment can take the form of cash, financial assets, nonfinancial assets, shares of the guarantor's stock or the provision of services. Therefore, both financial and nonfinancial contracts can be in the scope of Topic 460. Further, guarantee contracts that have net settlement provisions may also be in the scope of Topic 460 if the guarantor has a reasonable basis for concluding – at contract inception – that it is probable that the related asset, liability or equity security is of the guaranteed party (see Question 7.2.30). [460-10-15-5, 55-7]

Judgment may be required to determine whether a contract for providing services represents a guarantee with payment made through the provision of services (and therefore subject to Topic 460) versus a service contract that is not a guarantee (e.g. a contract that requires an entity to perform services regardless of changes in an underlying).

Question 7.2.70 Do a seller's representations and warranties about asset or liability values after a divestiture represent a type of guarantee in the scope of Topic 460?

Background: In divestitures, sellers may provide representations and warranties about the existence of assets at the sale closing date, or the value of assets or liabilities in periods after the closing date.

Interpretive response: Yes. When a guarantee or indemnification is entered into in connection with a divestiture, the guarantee or indemnity generally begins after the asset or liability is transferred to the buyer. This means a guarantee or indemnity of the value of the transferred asset or liability relates to an asset or liability *of the* guaranteed party (i.e. the buyer). Therefore, asset value guarantees or liability indemnities for periods after the closing date are in the scope of Topic 460. However, if the guarantee or indemnification prevents the guarantor from recording the sale or recognizing profit on the sale transaction, a scope exception applies (see Question 7.2.220).

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Question 7.2.80 What are examples of contracts that do not represent any of the types of guarantee contracts in Topic 460's scope?

Excerpt from ASC 460-10

General

• > Scope Guidance – Guarantees outside the Scope of This Topic Entirely

• • > Not of the Types Described

55-16 The following are examples of contracts that are outside the scope of this Topic because they are not of any of the types described in paragraph 460-10-15-4:

a. **Commercial letters of credit** and other loan commitments, which are commonly thought of as guarantees of funding, are not included in the scope of this Topic because those instruments do not guarantee payment of a money obligation and do not provide for payment in the event of default by the account party.
b. A noncontingent forward contract for which net settlement could involve a net settlement payment from either party is not included in the scope of this Topic. However, as discussed in paragraph 460-10-55-9, a contingent forward contract may meet one of the characteristics in paragraph 460-10-15-4 and be included in the scope of this Topic.
c. A guarantee provision in a financial instrument that is commonly thought of as a market value guarantee of the other terms of that same financial instrument is not within the scope of this Topic unless that guarantee provision is accounted for separately as a derivative under Topic 815 (see paragraph 460-10-25-1(a)). For example, a put option that is embedded in a puttable bond (but is not accounted for separately as a derivative) could be viewed by the investor (the guaranteed party) as a guarantee against the fair value of the remaining instrument (a bond absent the put option) declining below the put price. The embedded put option does not meet the characteristic in paragraph 460-10-15-4(a) because the guaranteed party's asset is an investment in the entire contract, a puttable bond, and not an investment in a nonputtable bond. However, as noted in paragraph 460-10-55-6, if the investor purchased a freestanding put option on a nonputtable bond and accounted for them separately, that guarantee would be within the scope of this Topic.
d. An arrangement, such as a securitization, that involves the subordination of the rights of some investors (or creditors) to the rights of others is commonly thought of as a guarantee issued by the subordinated investors. For example, the investors in one (subordinated) class or tranche of an entity's securities might not receive any cash flows until the investors in another (priority) class or tranche are fully paid. Although that type of subordination provides credit protection by the subordinated investors, it does not meet any of the characteristics in paragraph 460-10-15-4 and, thus, is not included in the scope of this Topic.
e. A written option that does not directly guarantee another entity's performance or the fair value of the guaranteed party's assets (such as a

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weather derivative) is not included in the scope of this Topic unless that written option is used as an indirect guarantee of the indebtedness of others.

f. A **take-or-pay contract** is not included in the scope of this Topic because the minimum payments under a take-or-pay contract are not contingent. A take-or-pay contract requires certain minimum payments irrespective of whether the buyer accepts delivery. Even if a take-or-pay contract were analyzed as though it were a guarantee by the buyer to pay for the portion of the minimum quantity of product or output of the guaranteed party for which the buyer refuses to order or accept delivery, a take-or-pay contract would not be included in the scope of this Topic because it would be a guarantee related to the buyer's future performance under the contract. (Take-or-pay contracts are further discussed in the Unconditional Purchase Obligations Subsections of Subtopic 440-10.)

g. A weather derivative is not included in the scope of this Topic because the climatic or geological variable is not an asset or liability of the guaranteed party. The characteristic in paragraph 460-10-15-4(a) requires payments to be based on changes in an underlying that is related only to an asset or liability of the guaranteed party.

Interpretive response: Topic 460 specifies that the following contracts are outside its scope because they are not of any of the types in Question 7.2.10. [460-10-55-16]

Contract	Explanation	Related reference
Commercial letters of credit and other loan commitments [460-10-55-16(a)]	Although these are commonly referred to as 'guarantees of funding,' they neither: • guarantee payment of a money obligation; nor • provide for payment only upon an event of default by the obligor.	Question 7.2.110 Example 7.2.20
Noncontingent net-settled forward contract [460-10-55-16(b)]	The types of guarantee contracts in Topic 460's scope require payments only if certain events or changes occur (see Question 7.2.30), while a noncontingent net-settled forward contract requires payment regardless of such events or changes occurring.	Question 7.2.130
Provision in a financial instrument that guarantees a minimum value of the financial instrument and is not bifurcated as an embedded derivative under Topic 815 [460-10-55-16(c)]	Although commonly referred to as a 'market value guarantee' for the guarantor, the provision represents a written put option on the financial instrument *excluding* the written put option, while for the guaranteed party the asset is the entire financial instrument (i.e. *including* the written put option). Therefore, the provision does not require payment based on an underlying related to an asset, liability or equity security *of the* guaranteed party.	Question 7.2.120 Example 7.2.30

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Contract	Explanation	Related reference
	However, a freestanding (or bifurcated embedded) written put option could represent a guarantee.	
Arrangements that subordinate some investors' rights to other investors' rights (e.g. securitization or partnership where investors in certain classes do not receive cash flows until investors in a more senior class are paid) [460-10-55-16(d)]	Although commonly referred to as a guarantee issued by the subordinated investors, the arrangement is not one of the types of guarantees in the scope of Topic 460.	
Written option contract that does not directly guarantee another entity's performance or the fair value of the guaranteed party's assets, unless the written option is used as an indirect guarantee of indebtedness of others [460-10-55-16(e)]	Guarantees in Topic 460's scope require payments only if another entity fails to perform under an obligating agreement or there are specified changes in an underlying that is related to an asset, liability or equity security of the guaranteed party (see Question 7.2.30). Other written option contracts are not in Topic 460's scope unless they indirectly guarantee indebtedness of others.	Question 7.2.170
Take-or-pay contract [460-10-55-16(f)]	Take-or-pay contracts require certain minimum payments regardless of whether the buyer accepts delivery; i.e. minimum payments under the contract are not contingent. Further, if viewed as a guarantee by the buyer to pay for the minimum quantity of product or output of the guaranteed party (regardless of whether the buyer orders or accepts delivery), a take-or-pay contract would not be in Topic 460's scope because it would be a guarantee related to the buyer's (i.e. the entity's own) future performance under the contract, which is excluded from Topic 460's scope (see Question 7.2.230).	See chapter 8 for guidance about disclosures under Topic 440.
Weather derivative [460-10-55-16(g)]	A weather derivative is based on a climatic or geological variable that is not an asset or liability of the guaranteed party.	Example 7.2.10

Note that the above table does not describe scope exceptions. Instead, it describes items that do not meet the characteristics of a guarantee described in

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the scope of Topic 460. In contrast, sections 7.2.30 and 7.2.40 describe contracts that meet the characteristics of a guarantee described in the scope of Topic 460 but are excluded either partially or fully from the scope.

Example 7.2.10 Weather derivative contract

ABC Corp (the guarantor) sells a weather derivative to Holder (the guaranteed party). Under the derivative contract, ABC is required to pay Holder if snowfall in California during February Year 1 is less than 6.5 feet.

Because the climatic or geological variable (i.e. the amount of snowfall during a specified timeframe) is not an asset or liability of Holder, the weather derivative is not in the scope of Topic 460.

See section 2.7.60 of KPMG Handbook, Derivatives and hedging, for further information about accounting for weather derivatives.

Financial guarantees

Question 7.2.90 What is a 'financial guarantee' under Topic 460?

Excerpt from ASC 460-10

General

• • > Financial Guarantees

55-2 The following are examples of contracts of the type described in paragraph 460-10-15-4(a):

a. A **financial standby letter of credit**
b. A market value guarantee on either a financial asset (such as a security) or a nonfinancial asset owned by the guaranteed party
c. A guarantee of the market price of the common stock of the guaranteed party
d. A guarantee of the collection of the scheduled contractual cash flows from individual financial assets held by a special-purpose entity
e. A guarantee granted to a business or its owner(s) that the revenue of the business (or a specific portion of the business) for a specified period of time will be at least a specified amount.

Interpretive response: A financial guarantee is a contract that contingently requires a guarantor to make payments to a guaranteed party based on changes in an underlying that is related to an asset, a liability or an equity security of the guaranteed party (see Question 7.2.30). [460-10-15-4(a), 55-2]

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Examples of financial guarantees are:

- financial standby letters of credit (see Question 7.2.110 and Example 7.2.20);
- a market value guarantee on an asset (whether financial or nonfinancial) owned by the guaranteed party (see Question 7.2.120);
- a guarantee of the market price of the common stock of the guaranteed party;
- a guarantee of the collection of the scheduled contractual cash flows from individual financial assets held by a special-purpose entity; and
- a guarantee granted to a business or its owner(s) that the revenue of the business (or a specific portion of the business) for a specified period of time will be at least a specified amount (see Question 7.2.140).

Question 7.2.100 Is a guarantee that accompanies the sale of real estate in Topic 460's scope?

Background: When a contract with a customer or noncustomer contains elements addressed by Topics other than Topic 606 or Subtopic 610-20, an entity first applies the separation and/or initial measurement requirements of those other Topics to those elements, as applicable. This includes applying Topic 460 to a guarantee element that is in the scope of its recognition and measurement guidance. [606-10-15-2, 15-4, 610-20-15-9]

Interpretive response: It depends. Many guarantees accompanying the sale of real estate are of the type that is in the scope of Topic 460 and do not qualify for a scope exclusion. However, certain guarantee-like arrangements involving real estate are not in the scope of Topic 460.

The following table provides examples of guarantees that often accompany real estate sales and other transactions involving real estate and illustrates whether they are in the scope of Topic 460.

Description of guarantee	Topic 460 scope analysis	Reference(s)
Seller's guarantee of a buyer's investment in real estate	Typically in scope – We believe a seller's guarantee of a buyer's investment (or a return on its investment) in real estate is typically similar to a market value guarantee on a nonfinancial asset owned by the guaranteed party, which is a type of guarantee in the scope of Topic 460. However, it is subject only to Topic 460's disclosure requirements if it is accounted for as a derivative under Topic 815. [460-10-15-4(a), 55-2(b)]	Question 7.2.90 Question 7.2.220 Question A40 of KPMG Handbook, Revenue: Real estate
Agreement to support operations of the real estate	Typically in scope – In our experience, these guarantees are generally analogous to guarantees of the	Question 7.2.90 Question 7.2.140

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Description of guarantee	Topic 460 scope analysis	Reference(s)
(e.g. support operations up to a break-even level of cash flows for a period of time after the sale)	collection of scheduled contractual cash flows from financial assets or business revenue, which are types of guarantees in the scope of Topic 460. [460-10-15-4(a), 55-2(d) – 55-2(e)]	Question A50 of KPMG Handbook, Revenue: Real estate
Seller/developer of land with an accompanying construction contract with a service-related guarantee that requires the seller to pay a penalty if not fulfilled, where the arrangement represents a single performance obligation in Topic 606 or Subtopic 610-20	Typically not in scope – Such guarantees typically represent a guarantee of the seller's own future performance and, therefore, are not in the scope of Topic 460. [460-10-15-7(i)]	Question 7.2.230 Example 7.2.40 Question A40 of KPMG Handbook, Revenue: Real estate

Question 7.2.110 Do all letters of credit represent financial guarantees in Topic 460's scope?

Interpretive response: No. Although all letters of credit are thought of as guarantees of funding, they are not all financial guarantees. Topic 460 distinguishes a financial standby letter of credit from a commercial letter of credit as explained in the table below. [460-10 Glossary, 55-2(a), 55-16(a)]

	Type	
	Financial standby letter of credit	**Commercial letter of credit**
ASC Glossary definition	An irrevocable undertaking (typically by a financial institution) to guarantee payment of a specified financial obligation.	A document issued typically by a financial institution on behalf of its customer (the account party) authorizing a third party (the beneficiary), or in special cases the account party, to draw drafts on the institution up to a stipulated amount and with specified terms and conditions; it is a conditional commitment (except if prepaid by the account party) on the part of the institution to provide payment on drafts drawn in accordance with the terms of the document.

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	Type	
	Financial standby letter of credit	**Commercial letter of credit**
Additional description	Standby letters of credit are typically used to guarantee payment by US entities under purchase contracts with foreign corporations and foreign or domestic governments in the event the US entity fails to pay. Under a standby letter of credit, the issuing institution (e.g. a financial institution) guarantees that the buyer (the US entity) will pay. The issuing institution is not ordinarily expected to pay.	A commercial letter of credit is a special type of agreement used to provide assurance for both parties involved in foreign trade transactions. Instead of the buyer paying the seller directly, the buyer enters into a commercial letter of credit with a financial institution (e.g. a bank) and the bank pays the seller on the buyer's behalf if the conditions of the commercial letter of credit are met.
Financial guarantee?	Yes	No
Explanation	A standby letter of credit contingently requires the guarantor to pay if a specified party fails to perform under an obligating agreement.	When payment is made under a commercial letter of credit, neither party has failed to meet an obligation (because payment is made upon both parties satisfying their obligations) and no change in an underlying that is related to an asset of the guaranteed party has occurred.

Financial standby letters of credit are also distinguished from other loan commitments in that they do not have material adverse change (MAC) clauses or similar provisions that enable the issuing institution (the guarantor) to avoid making a payment (that is, financial standby letters of credit are irrevocable). In contrast, many loan commitments are not financial guarantees because they are revocable under MAC clauses or other similar provisions that enable the issuing institution to avoid making a loan if the borrower encounters financial difficulties after the loan commitment is issued. [FIN 45.A9(b)]

Example 7.2.20 Commercial letter of credit vs financial standby letter of credit

US Corp wants to purchase equipment manufactured by Foreign Corp. Foreign Corp does not want to ship the equipment without advance payment, because it is concerned that US Corp might be unable to pay for it. Similarly, US Corp does not want to pay in advance because Foreign Corp may fail to ship the equipment.

Scenario 1: Commercial letter of credit

Bank issues a commercial letter of credit that honors a draft drawn against the bank account of US Corp for the equipment's purchase price. The letter

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requires the draft to be accompanied by a bill of lading and other applicable evidence that Foreign Corp loaded the equipment on a ship bound for a specific US port and that entitles US Corp to possess the equipment upon arrival. Bank pays Foreign Corp for the specified amount once it receives the requisite evidence.

This does not represent a financial guarantee under Topic 460 because, at the time of payment, neither US Corp nor Foreign Corp had failed to meet an obligation and there was no change in an underlying that is related to an asset of Foreign Corp.

Scenario 2: Financial standby letter of credit

Bank issues a standby letter of credit that guarantees US Corp will pay Foreign Corp. Bank is not obligated to make any payment to Foreign Corp unless US Corp fails to pay.

This represents a financial guarantee under Topic 460 because Bank (the guarantor) is contingently required to pay Foreign Corp (the guaranteed party) if US Corp fails to perform under the agreement.

Question 7.2.120 Is a freestanding written put option a market value guarantee in the scope of Topic 460?

Excerpt from ASC 460-10

General

• • • > Option-Based Contracts

55-3 Option-based contracts in which any net potential contingent payment can flow only from the guarantor to the guaranteed party may meet one of the characteristics in paragraph 460-10-15-4 and be included in the scope of this Topic. (Some guarantees obligate the guaranteed party to pay all or a portion of the premium to the guarantor at a later date; those premium payments are not contingent payments as discussed in the previous sentence.)

55-4 A put option is a market value guarantee because it gives the holder the right to sell a specified quantity of an asset related to the **underlying** to the writer of the option at a specified price (strike price) up to the expiration date. For example, paragraphs 860-20-55-20 through 55-23 address the interaction of various Subtopics (including this Subtopic) in accounting for transactions that involve sale of a marketable security to a third-party buyer, with the buyer's having an option to put the security back to the seller at a specified future date or dates for a fixed price.

55-5 Paragraph 460-10-15-4(a) states that the provisions of this Topic apply to a guarantee contract that contingently requires a guarantor to make payments to a guaranteed party based on changes in an underlying that is related to an asset, a liability, or an equity security of the guaranteed party. This paragraph addresses whether the characteristic in paragraph 460-10-15-4(a) is met for a put option written by a guarantor that did not know whether the guaranteed

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party had an asset or liability related to the underlying described in paragraph 460-10-15-4(a). If, upon exercise, the put option requires gross settlement and the asset to be delivered under gross settlement is related to the underlying described in paragraph 460-10-15-4(a), characteristic (a) in paragraph 460-10-15-4 shall be considered to be met.

55-6 For example, if an investor entered into two separate contracts—a nonputtable bond and a freestanding put option contract that can be settled only by delivery of the bond—and was accounting for those contracts separately, that freestanding put option contract would be a guarantee that meets the characteristic in paragraph 460-10-15-4(a).

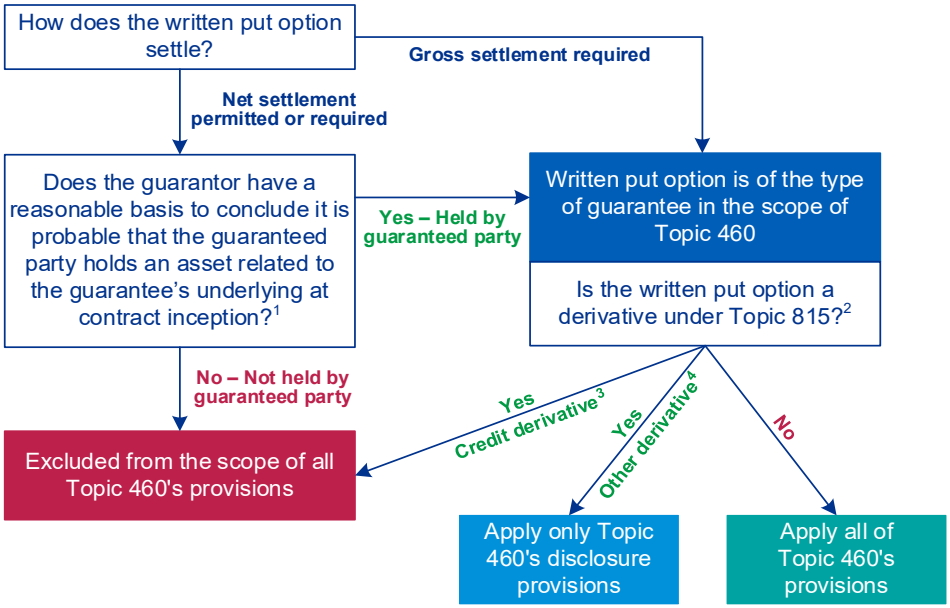
55-7 In contrast, if a put option permits or requires net settlement, the guarantor must consider its business relationship with the guaranteed party and the other circumstances involved in the issuance of the put option in deciding whether it is **probable** that the guaranteed party has, on or about the date of the put option's issuance, an asset or liability related to the underlying described in paragraph 460-10-15-4(a). If the guarantor has no basis for concluding that it is probable that the guaranteed party has that asset or liability, the characteristic in that paragraph would not be met for that written put option and it would not be within the scope of this Topic.

55-8 For a put option that permits or requires net settlement and for which the characteristic in paragraph 460-10-15-4(a) is considered to be met at inception, the guarantor shall continue complying with the disclosure requirements of the General Subsection of Section 460–10–50 over the term of the put option without an ongoing assessment of whether the guaranteed party continues to have the related asset or liability over that period.

Background: A put option is an agreement that gives the buyer (option holder) the right to sell an underlying asset to the issuer (option writer) at an agreed-upon price (exercise price). This enables the option holder to benefit from a decrease in the value of the underlying asset below the exercise price.

Interpretive response: It depends on whether payments under the guarantee relate to an asset or liability of the guaranteed party (see Question 7.2.30). If the put option requires gross settlement, this condition is deemed to be met. Otherwise, the entity must evaluate whether the condition is met. The following decision tree summarizes the considerations in this evaluation.

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Notes:

1. As explained in Question 7.2.30, this assessment may require significant judgment and is based on the facts and circumstances about the specific arrangement and the relationship between the parties.
2. See chapters 2 and 3 of KPMG Handbook, Derivatives and hedging.
3. See Question 7.2.210 for discussion of credit derivatives.
4. See Question 7.2.250 for discussion of derivatives other than credit derivatives.

Example 7.2.30 Puttable bond vs nonputtable bond

Scenario 1: Puttable bond

On March 1, Year 1, ABC Corp issues a puttable bond to Investor for $1,000 that matures on February 28, Year 10. The bond's terms permit Investor to require ABC to repurchase the bond for $1,000 any time after March 1, Year 5 (i.e. it contains an embedded put option). ABC does not separately account for the embedded put option as an embedded derivative.

Although the embedded put option could be viewed as a guarantee of the fair value of the remaining instrument (i.e. guarantee of a nonputtable bond's fair value), Holder's asset is an investment in the entire contract and not in a nonputtable bond. Therefore, the embedded put option is not in the scope of Topic 460.

Scenario 2: Nonputtable bond and net settleable written put option

On March 1, Year 1, ABC issues a nonputtable bond to Investor for $1,000 that matures on February 28, Year 10. Also on that date, ABC writes a put option to Investor that permits the option holder to require ABC to repurchase the bond for $1,000 any time after March 1, Year 5. The written put option permits net settlement. ABC concludes that the bond and written put option are each freestanding instruments (for guidance on determining whether an instrument

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is freestanding, see section 6.3 of KPMG Handbook, Debt and equity financing). Further, at inception, ABC has a reasonable basis to conclude it is probable Investor holds the bond (i.e. the bond is an asset of Investor).

The freestanding put option is a guarantee in the scope of Topic 460. However, if it is a derivative in the scope of Topic 815, it is excluded from either all or some of Topic 460's provisions, depending on whether it is a credit derivative.

- **Credit derivative**: The put option is excluded from Topic 460 in its entirety (see Question 7.2.210).
- **Not a credit derivative**: The put option is excluded from Topic 460's general recognition and measurement provisions but Topic 460's disclosure requirements still apply (see Question 7.2.250).

Question 7.2.130 Do forward contracts represent financial guarantees in the scope of Topic 460?

Excerpt from ASC 460-10

General

• • • > Contingent Forward Contracts

55-9 Contingent forward contracts may meet one of the characteristics in paragraph 460-10-15-4 and be included in the scope of this Topic. A freestanding put option contract that can be settled only by delivery of the asset related to the underlying could be viewed as a contingent forward contract.

Interpretive response: It depends. A *noncontingent* forward contract is not in the scope of Topic 460 as explained in Question 7.2.80. However, a *contingent* forward contract may be one of the types of guarantees in the scope of Topic 460 (see Question 7.2.10). For example, a freestanding written put option that can be settled only by delivery of the asset related to the underlying is essentially a contingent forward contract that is in Topic 460's scope. [460-10-55-9]

Question 7.2.140 Do minimum revenue guarantees or other analogous guarantees represent financial guarantees in the scope of Topic 460?

Excerpt from ASC 460-10

General

• • • > Minimum Revenue Guarantees

55-10 An example of the type of guarantee described in paragraph 460-10-55-2(e) is a **minimum revenue guarantee** granted to a new day-care center by a

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corporation as an incentive for the center to locate near the corporation's main plant. The corporation, as the guarantor, has agreed to make monthly payments to the day-care center (the guaranteed party) over a specified term for any shortfall from the guaranteed minimum amount of revenue for each month.

55-11 Another example is a guarantee granted to a nonemployee physician by a not-for-profit health care facility that has recruited the physician to move to the facility's geographical area to establish a practice. The health care facility, as the guarantor, has agreed to make payments to the newly arrived physician (the guaranteed party) at the end of specific periods of time if the gross revenues (gross receipts) generated by the physician's new practice during that period of time do not equal or exceed a specific dollar amount. This Topic applies to minimum revenue guarantees granted to physicians regardless of whether the physician's practice qualifies as a **business**.

Background: Minimum revenue guarantees are guarantees granted to a business or its owners that the revenue of the business (or a specific portion of the business) for a specified period of time will be at least a specified minimum amount. [460-10 Glossary]

Interpretive response: Yes, minimum revenue guarantees are financial guarantees because the business's gross revenue represents the guarantee's underlying and it is considered related to an asset or equity security of the guaranteed party. This is the case regardless of whether the guaranteed party is the business owner or the business itself.

- **Business owner:** The business's gross revenues relate to changes in the owner's investment in the business (an equity security of the guaranteed party).
- **Business itself:** The business's gross revenues relate to changes in the business's net assets.

In addition, we believe guarantees of earnings or expense levels are generally analogous to guarantees of the collection of scheduled contractual cash flows from financial assets or business revenues and, as a result, also represent financial guarantees.

Performance guarantees

Question 7.2.150 What is a 'performance guarantee' under Topic 460?

Excerpt from ASC 460-10

General

• • > Performance Guarantees

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55-12 The following are examples of contracts of the type described in paragraph 460-10-15-4(b):

a. **Performance standby letters of credit**
b. Bid bonds
c. Performance bonds
d. Other contracts that are similar to performance standby letters of credit.

Interpretive response: A performance guarantee is a contract that contingently requires a guarantor to make payments to a guaranteed party based on another entity's failure to perform under an obligating agreement (see Question 7.2.10). [460-10-15-4(b)]

An example of a performance guarantee is a performance standby letter of credit, which is an irrevocable undertaking by a guarantor to make payments if a specified third party fails to perform under a *nonfinancial* contractual obligation. In comparison, a financial standby letter of credit requires the guarantor to make payment to the guaranteed party if a third party defaults on a specified *financial* obligation (see Question 7.2.110). Both letters of credit are guarantees under Topic 460, although they are different types of contracts. [460-10-55-12(a)]

Other examples of performance guarantees are bid bonds, performance bonds and other contracts that are similar to standby letters of credit. [460-10-55-12]

Indemnification agreements

Question 7.2.160 What is an 'indemnification agreement' under Topic 460?

Excerpt from ASC 460-10

General

• • > Indemnifications

55-13 The following are examples of contracts of the type described in paragraph 460-10-15-4(c):

a. An indemnification agreement (contract) that contingently requires the indemnifying party (guarantor) to make payments to the indemnified party (guaranteed party) based on an adverse judgment in a lawsuit or the imposition of additional taxes due to either a change in the tax law or an adverse interpretation of the tax law.
b. A lessee's indemnification of the lessor for any adverse tax consequences that may arise from a change in the tax laws, because only a legislative body can change the tax laws, and the lessee therefore has no control over whether payments will be required under that indemnification. In contrast, as discussed in paragraph 460-10-55-18(a), when a lessee indemnifies a lessor against adverse tax consequences that may arise from acts, omissions, and misrepresentations of the lessee, that indemnification is

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outside the scope of this Topic because the lessee is, in effect, guaranteeing its own future performance.

c. A seller's indemnification against additional income taxes due for years before a business combination, because the indemnification relates to the seller-guarantor's past performance, not its future performance.

Interpretive response: Indemnification agreements are contracts that contingently require an indemnifying party (the guarantor) to make payments to an indemnified party (the guaranteed party) based on changes in an underlying that is related to an asset, a liability or an equity security of the guaranteed party (see Question 7.2.10). [460-10-15-4(c)]

The following table identifies examples of such agreements that are in the scope of Topic 460.

Agreement terms	Description/Explanation
Indemnifying party (guarantor) agrees to make payments to the indemnified party (guaranteed party) upon a specified contingent event occurring.	Examples include agreements under which payment is made if: • an adverse judgment is made in a lawsuit; or • additional taxes are imposed on the indemnified party due to a change in – or an adverse interpretation of – the tax law.
Lessee (indemnifying party/guarantor) agrees to make payments to the lessor (indemnified/guaranteed party) for any adverse tax consequences arising from a change in tax law.	Only a legislative body can change the tax laws, so the lessee does not control whether payments will be required under the indemnification. In contrast, a lessee's indemnification of a lessor against adverse tax consequences that may arise from the lessee's acts, omissions and misrepresentations is excluded from the scope of Topic 460 because the lessee is guaranteeing its own future performance (see Question 7.2.230).
Seller (guarantor) indemnifies the acquirer (guaranteed party) for additional income taxes due for years before a business combination.	Although the guarantee relates to the seller's own performance, it is not excluded from Topic 460's scope because it relates to the seller's past (not future) performance (see Question 7.2.230).

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Indirect guarantees of indebtedness

Question 7.2.170 What is an 'indirect guarantee of indebtedness' under Topic 460?

Interpretive response: An indirect guarantee of indebtedness is an agreement: [460-10 Glossary]

- that obligates the guarantor to transfer funds to a debtor if specified events occur;
- under which the transferred funds become legally available to creditors through their claims against the debtor; and
- that permits those creditors to enforce the debtor's claims against the guarantor.

In this situation, the debtor is an intermediary between the creditor and the guarantor. This contrasts with a direct guarantee of indebtedness in which the creditor has a direct claim on the guarantor for amounts owed by the debtor if the debtor defaults.

Question 7.2.180 Is a philanthropic organization's guarantee of a not-for-profit's debt to a bank in the scope of Topic 460?

Excerpt from ASC 460-10

• • > Indirect Guarantees of the Indebtedness of Others

55-14 The following is an example of a contract of the type described in paragraph 460-10-15-4(d).

55-15 A community foundation has a loan guarantee program to assist not-for-profit entities (NFPs) in obtaining bank financing at a reasonable cost. Under that program, the community foundation issues a guarantee of an NFP's bank debt. That guarantee is within the scope of this Topic, and on the issuance of the guarantee, the community foundation would recognize a liability for the **fair value** of that guarantee. The issuance of that guarantee would not be considered merely a conditional promise to give under paragraphs 958-605-25-11 through 25-13 because, upon the issuance of the guarantee, the NFP will have received the gift of the community foundation's credit support. That credit support enables the NFP to obtain a lower interest rate on its borrowing.

Interpretive response: Yes, because it represents either an indirect guarantee of indebtedness (if the not-for-profit is the guaranteed party) or a financial guarantee (if the bank is the guaranteed party). The not-for-profit entity receives a lower rate on the bank debt because of the guarantee. That is, the not-for-profit entity has received support at the guarantee's issuance and the issuance of the guarantee does not represent a conditional promise to give under Topic 958 (not-for-profit entities).

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7.2.30 Guarantees excluded from all provisions of Topic 460

Excerpt from ASC 460-10

• > Transactions That Are Excluded from the Scope of This Topic

15-7 The guidance in this Topic does not apply to the following types of guarantee contracts:

a. A guarantee or an indemnification that is excluded from the scope of Topic 450 (see paragraph 450-20-15-2—primarily employment-related guarantees).
b. A lessee's guarantee of the residual value of the **underlying asset** at the expiration of the **lease term** under Topic 842.
c. A contract that meets the characteristics in paragraph 460-10-15-4(a) but is accounted for as **variable lease payments** under Topic 842.
d. A guarantee (or an indemnification) that is issued by either an insurance entity or a **reinsurance** entity and accounted for under Topic 944 (including guarantees embedded in either insurance contracts or investment contracts).
e. A contract that meets the characteristics in paragraph 460-10-15-4(a) but provides for payments that constitute a vendor rebate (by the guarantor) based on either the sales revenues of, or the number of units sold by, the guaranteed party.
f. A contract that provides for payments that constitute a vendor rebate (by the guarantor) based on the volume of purchases by the buyer (because the underlying relates to an asset of the seller, not the buyer who receives the rebates).
g. A guarantee or an indemnification whose existence prevents the guarantor from being able to either account for a transaction as the sale of an asset that is related to the guarantee's underlying or recognize in earnings the profit from that sale transaction.
h. A **registration payment arrangement** within the scope of Subtopic 825-20 (see Section 825-20-15).
i. A guarantee or an indemnification of an entity's own future performance (for example, a guarantee that the guarantor will not take a certain future action).
j. A guarantee that is accounted for as a **credit derivative** at fair value under Topic 815.
k. A sales incentive program in which a manufacturer contractually guarantees to reacquire the equipment at a guaranteed price or guaranteed prices at a specified time, or at specified time periods (for example, the entity is obligated to reacquire the equipment or the entity is obligated at the **customer's** request to reacquire the equipment). That program shall be evaluated in accordance with Topic 606 on **revenue** from **contracts** with customers, specifically the implementation guidance on repurchase agreements in paragraphs 606-10-55-66 through 55-78.

Certain guarantee contracts fall in one of the four types of guarantees in the scope of Topic 460 (see Question 7.2.10) but they are specifically excluded from Topic 460's scope entirely – i.e. excluded from its recognition,

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measurement and disclosure provisions. The 11 scope exceptions listed in the above Excerpt fall into four categories, as summarized in the following table.

Scope exceptions from all of Topic 460's guidance	Applicable exception(s)	Additional information
Guarantees or indemnifications that are excluded from Topic 450's scope – primarily employment-related guarantees	460-10-15-7(a)	Question 7.2.190
Guarantees in the scope of certain other Topics/Subtopics	460-10-15-7(b) to (f), (h), (j) and (k)	Question 7.2.200
Guarantees or indemnifications whose existence prevents sale accounting	460-10-15-7(g)	Question 7.2.220
Guarantees or indemnifications of an entity's own future performance	460-10-15-7(i)	Question 7.2.230 Example 7.2.40

Question 7.2.190 Are directors' and officers' indemnification agreements in Topic 460's scope?

Interpretive response: No. Agreements to indemnify an entity's directors (including nonemployee directors who are deemed employees under Topic 718) and officers against litigation arising from employment are excluded from the scope of Topic 460 because they meet one or both of the following scope exceptions in Topic 460.

- **Guarantees or indemnifications that are excluded from the scope of Topic 450**: Costs associated with directors' and officers' indemnification agreements represent employee-related costs, which are excluded from the scope of Topic 450. [460-10-15-7(a)]
- **Guarantees or indemnifications of an entity's own future performance:** Because a company acts through its employees, the indemnification of directors and officers is considered a guarantee of the company's own future performance (see Question 7.2.230).

Question 7.2.200 What scope exceptions from Topic 460 are provided for guarantees in the scope of other Topics/Subtopics?

Interpretive response: The following table summarizes scope exceptions from Topic 460 for guarantees that are in the scope of other Topics/Subtopics. [460-10-15-7]

Guarantee	Applicable Topic/Subtopic	KPMG resource
Financial guarantee that provides for payments that constitute a vendor rebate (by the guarantor) based on sales	Topic 606	KPMG Handbook, Revenue recognition

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Guarantee	Applicable Topic/Subtopic	KPMG resource
revenues of, or number of units sold by, the guaranteed party [460-10-15-7(e)]		
Contract that provides for payments that constitute a vendor rebate (by the guarantor) based on the volume of purchases by the buyer (because the underlying relates to an asset of the seller, not the buyer who receives the rebates) [460-10-15-7(f)]	Topic 606	KPMG Handbook, Revenue recognition
A sales incentive program that includes a provision under which a manufacturer contractually guarantees to reacquire equipment at a guaranteed price [460-10-15-7(k)]	Topic 606	KPMG Handbook, Revenue recognition
Lessee guarantee of the residual value of leased property at expiration of the lease under Topic 842 [460-10-15-7(b)]	Topic 842	KPMG Handbook, Leases
Financial guarantee accounted for as a variable lease payment under Topic 842 [460-10-15-7(c)]	Topic 842	KPMG Handbook, Leases
Guarantee/indemnification issued by an insurance entity or reinsurance entity [460-10-15-7(d)]	Topic 944	KPMG Handbook, Long-duration contracts
Registration payment arrangements [460-10-15-7(h)] See Excerpt below. In brief, these are arrangements requiring an issuer to: [825-10 Glossary] • file (or maintain effectiveness of) a registration statement for the resale of certain financial instruments or equity shares; and • transfer consideration to the counterparty if the registration statement is not declared effective or its effectiveness is not maintained.	Topic 825	N/A
Credit derivatives [460-10-15-7(j)]	Topic 815	Question 7.2.210 KPMG Handbook, Derivatives and hedging

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Excerpt from ASC 825-10

20 Glossary

Registration Payment Arrangement

An arrangement with both of the following characteristics:

a. It specifies that the issuer will endeavor to do either of the following:
   1. File a registration statement for the resale of specified financial instruments and/or for the resale of equity shares that are issuable upon exercise or conversion of specified financial instruments and for that registration statement to be declared effective by the U.S. Securities and Exchange Commission (SEC) (or other applicable securities regulator if the registration statement will be filed in a foreign jurisdiction) within a specified grace period
   2. Maintain the effectiveness of the registration statement for a specified period of time (or in perpetuity).

b. It requires the issuer to transfer consideration to the counterparty if the registration statement for the resale of the financial instrument or instruments subject to the arrangement is not declared effective or if effectiveness of the registration statement is not maintained. That consideration may be payable in a lump sum or it may be payable periodically, and the form of the consideration may vary. For example, the consideration may be in the form of cash, equity instruments, or adjustments to the terms of the financial instrument or instruments that are subject to the registration payment arrangement (such as an increased interest rate on a debt instrument).

Question 7.2.210 What is a 'credit derivative' that qualifies for a scope exception from all provisions of Topic 460?

Interpretive response: A credit derivative is a derivative instrument that has both of the following characteristics.

- One or more of its underlyings are related to any of the following:
  - the credit risk of a specified entity (or a group of entities); and/or
  - an index based on the credit risk of a group of entities.
- It exposes the seller to potential loss from credit-risk-related events specified in the contract.

Examples include, but are not limited to, credit default swaps, credit spread options and credit index products. [460-10 Glossary]

A credit derivative is excluded from all provisions of Topic 460. In contrast, other derivatives accounted for under Topic 815 that are of the type of contract in the scope of Topic 460 are subject to a scope exception only from Topic

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460's recognition and measurement provisions; Topic 460's disclosure provisions still apply (see Question 7.2.250).

Question 7.2.220 What are guarantees that prevent sale accounting?

Excerpt from ASC 460-10

General

• • > Guarantees that Prevent Sale Accounting

55-17 The following is an example of a contract that is outside the scope of this Topic because it is of the type described in paragraph 460-10-15-7(g): …

c. A transaction that involves sale of a marketable security to a third-party buyer with the buyer having an option to put the security back to the seller at a specified future date or dates for a fixed price, if the existence of the put option prevents the transferor from accounting for the transaction as a sale, as described in paragraphs 860-20-55-20 through 55-23.

Interpretive response: Guarantee arrangements are excluded from the scope of Topic 460 if they prevent the guarantor from: [460-10-15-7(g)]

- accounting for the transaction as a sale of an asset related to the guarantee's underlying; or
- recognizing the profit from that sale transaction in earnings.

Topic 460 provides one example of a guarantee that prevents sale accounting. When the transfer of a financial asset together with an embedded put option results in the transfer not being accounted for as a sale under Topic 860, the put option is not accounted for as a guarantee. [460-10-55-17(c)]

See also Questions 7.2.110 and 8.2.70 of KPMG Handbook, Transfers and servicing of financial assets, for guidance about how to account for a transfer of a financial asset together with a put option, depending on whether sale accounting is appropriate.

Question 7.2.230 What are examples of guarantees or indemnifications of an entity's own future performance?

Excerpt from ASC 460-10

General

• • > Guarantees of an entity's own performance

55-18 The following are examples of contracts that are outside the scope of this Topic because these contracts are of the type described in paragraph 460-10-15-7(i):

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a. A lessee will often indemnify a lessor for any adverse tax consequences that may arise from acts, omissions, and misrepresentations of the lessee (for example, using the leased asset outside the United States or subleasing to a tax-exempt entity). The lessee is, in effect, guaranteeing that its own future performance and actions with respect to the lease and the leased property will not result in adverse tax consequences to the lessor. Thus, that lessee's indemnification is not within the scope of this Topic. In contrast, as discussed in paragraph 460-10-55-13(b), a guarantee by a lessee regarding the effect of future changes in the tax law on the guaranteed party's tax liability is within the scope of this Topic because the lessee cannot change the tax law (or prevent a change) and thus cannot control whether payments will be required under the guarantee.
b. An entity's guarantee of its own future performance, such as that entity's completion of a contract by a specified deadline is not within the scope of this Topic.
c. In consolidated financial statements, a parent's guarantee of a subsidiary's debt to a third party would simply be a guarantee of the consolidated entity's own performance to make the scheduled payments on that consolidated liability, which is not a guarantee within the scope of this Topic for the consolidated reporting entity.

Interpretive response: Guarantees or indemnifications of an entity's own future performance are excluded from Topic 460's scope, e.g. a guarantee that the guarantor will not take a certain future action. [460-10-15-7(i)]

This scope exception does not apply to guarantees or indemnifications of the entity's *past* performance. Further, it does not apply to guarantees or indemnifications related to the performance of another entity, whether future or past (see Question 7.2.260 for additional considerations when entities are under common control). Those guarantees or indemnifications are in the scope of Topic 460 if they are of the type of contract in its scope and another scope exception does not apply.

The following table summarizes examples of guarantees whose terms meet – versus do not meet – this scope exception. [460-10-55-18]

Contract type	Guarantee terms that meet the scope exception	Guarantee terms that do not meet the scope exception
Lessee indemnification of Lessor (see also Question 7.2.160)	Lessor is indemnified for any adverse tax consequences that may arise from future acts, omissions and misrepresentations of the lessee, such as using the leased asset outside the US or subleasing to a tax-exempt entity.	Lessee guarantees the effect of future changes in tax law on the Lessor's existing tax liability.
Guarantee related to construction (see Question 7.2.100)	Construction company guarantees it will complete a project by a specified date.	Guarantor guarantees that an independent third-party construction company will complete a project by a specified date.

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Contract type	Guarantee terms that meet the scope exception	Guarantee terms that do not meet the scope exception
Investor guarantee of Investee's debt owed to a third party	Investor consolidates Investee and the reporting entity is the consolidated entity (see Question 7.2.260).	• Investor accounts for the investment as an equity method investment (see Question 7.2.240). • Investor consolidates Investee and the reporting entity is Investor on a stand-alone basis (see Question 7.2.260).

Example 7.2.40 Fraud protection services

Fraud Detector Corp provides an algorithm service in a hosted environment to perform fraud evaluations for Widget Seller (customer). Widget Seller uses Fraud Detector's algorithm service in deciding whether to approve sales to widget buyers (third parties). Under the contract, Fraud Detector pays Widget Seller for fraud losses resulting from transactions the algorithm advised approving.

The exclusion from Topic 460's provisions for guarantees of an entity's own performance does not apply to Fraud Detector's obligation to pay Widget Seller for fraud losses because Fraud Detector's obligation to pay Widget Seller is based on a third party's performance (i.e. a widget buyer's fraudulent behavior). Further, it does not represent a product warranty (see section 7.6) and, therefore, is subject to Topic 460's general recognition and measurement guidance (see section 7.3).

Question 7.2.240 Is an investor's guarantee of its equity method investee's debt to a third party a guarantee of its own performance?

Interpretive response: No. To be a guarantee of a reporting entity's own performance, the guarantee must relate to the performance of an entity included in the reporting entity's consolidated financial statements. An equity method investee is not included in the investor's consolidated group. An investor's guarantee to make payments if its equity method investee defaults on its debt to a third party represents a guarantee of the investee's performance – not the investor's own performance. Therefore, an investor's guarantee of its equity method investee's debt is not eligible for the scope exception for guarantees of an entity's own performance.

See Question 7.2.260 for Topic 460 scope considerations when the guarantor and either the guaranteed party or the entity holding the guarantee are in a common control group. Whether disclosures are required for guarantees among

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entities in a common control group depends on the specific circumstances, as discussed in Question 7.2.260.

7.2.40 Guarantees excluded from Topic 460's recognition and measurement provisions

Excerpt from ASC 460-10

General

25-1 The following types of guarantees are not subject to the recognition provisions of this Subsection:

a. A guarantee that is accounted for as a derivative instrument at fair value under Topic 815.
b. A product **warranty** or other guarantee for which the **underlying** is related to the performance (regarding function, not price) of nonfinancial assets that are owned by the guaranteed party (see paragraph 460-10-15-9 for related guidance).
c. A guarantee issued in a business combination or an **acquisition by a not-for-profit entity** that represents contingent consideration (as addressed in Subtopics 805-30 and 958-805).
d. A guarantee for which the guarantor's obligation would be reported as an equity item rather than a liability under generally accepted accounting principles (GAAP) (see Topics 480 and 505).
e. A guarantee by an original **lessee** that has become secondarily liable under a new **lease** that relieved the original lessee from being the primary obligor (that is, principal debtor) under the original lease, as discussed in paragraph 842-20-40-3. This exception shall not be applied by analogy to secondary obligations.
f. A guarantee issued either between parents and their subsidiaries or between corporations under common control.
g. A parent's guarantee of its subsidiary's debt to a third party (whether the parent is a corporation or an individual).
h. A subsidiary's guarantee of the debt owed to a third party by either its parent or another subsidiary of that parent.

Several types of guarantees – listed in the above Excerpt – are excluded from Topic 460's general recognition and measurement provisions but not from its disclosure provisions. These types fall into the following two categories; in addition, Topic 460 provides separate scoping, recognition and measurement guidance for product warranties (see section 7.6).

Scope exceptions from Topic 460's general recognition and measurement guidance	Reference
Guarantees in the scope of certain other Topics/Subtopics	Question 7.2.250
Guarantees issued between entities under common control	Question 7.2.260 Example 7.2.50

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Question 7.2.250 What scope exceptions from Topic 460's recognition and measurement provisions apply to guarantees in the scope of other Topics/Subtopics?

Interpretive response: The following table summarizes scope exceptions from Topic 460's recognition and measurement provisions for guarantees that are in the scope of other Topics/Subtopics. [460-10-25-1]

Guarantee	Applicable Topic/Subtopic	KPMG resource
Derivative instruments accounted for at fair value under Topic 815 (note that credit derivatives are excluded from *all* provisions of Topic 460 – not just the recognition and measurement provisions – see Question 7.2.210)	• Topic 815	Chapters 2 and 3 of KPMG Handbook, Derivatives and hedging
Contingent consideration in a business combination or an acquisition by a not-for-profit entity	• Subtopic 805-30 • Subtopic 958-805	Section 6 of KPMG Handbook, Business combinations
Guarantee obligation that is classified as equity	• Topic 480 • Topic 505 • Subtopic 815-40	Question 7.2.280 Chapters 5, 6 and 8 of KPMG Handbook, Debt and equity financing
Guarantee of a lease where the guarantor was an original lessee that became secondarily liable for the lease after being released as primary obligor (i.e. principal debtor) under the original lease	• Topic 842	Question 8.2.20 of KPMG Handbook, Leases

Question 7.2.260 What guarantees issued between entities under common control are excluded from Topic 460's recognition and measurement provisions?

Interpretive response: Guarantees between entities under common control (e.g. parents, subsidiaries, sister companies) are excluded from Topic 460 either entirely or only from its recognition and measurement provisions. Which scope exception applies depends on whether the guarantor and guaranteed party are both included in the reporting entity's consolidated financial statements. [460-10-15-7(i), 25-1]

- **Guarantor and guaranteed party are both included in the reporting entity's consolidated financial statements**: The guarantee is excluded from all of Topic 460's provisions because it either eliminates in

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consolidation or is a guarantee of the consolidated entity's own performance (see Question 7.2.230).

- **Guarantor and guaranteed party are *not* both included in the reporting entity's consolidated financial statements:** The guarantee is excluded only from Topic 460's recognition and measurement provisions under the common control scope exception but is subject to Topic 460's disclosure requirements.

Example 7.2.50 Guarantees of debt – common control scope exceptions

The following table outlines five scenarios and whether a scope exception from Topic 460 applies. In all scenarios, an entity has issued debt to a third party and that debt is guaranteed by another entity.

Scenario	Topic 460 scope exception	Explanation
Investor's guarantee of Equity Method Investee's debt	None	Entities are not under common control (see Question 7.2.240).
Parent's guarantee of controlled Subsidiary's debt in Parent's consolidated financial statements	Excluded entirely from scope of Topic 460	Guarantee eliminates in consolidation or is a guarantee of the consolidated entity's own performance (see Question 7.2.260).
Parent's guarantee of controlled Subsidiary's debt in Parent's stand-alone financial information	Excluded from Topic 460's recognition and measurement provisions, but subject to Topic 460's disclosure provisions	Entities are under common control, but are not consolidated in the information presented.
Subsidiary A's guarantee of Subsidiary B's debt in Parent's consolidated financial statements (which includes both subsidiaries)	Excluded entirely from scope of Topic 460	Guarantee eliminates in consolidation or is a guarantee of the consolidated entity's own performance (see Question 7.2.260).
Subsidiary A's guarantee of Subsidiary B's debt in Subsidiary A's stand-alone financial statements; Subsidiary A and B are both under common control of Parent	Excluded from Topic 460's recognition and measurement provisions, but subject to Topic 460's disclosure provisions	Entities are under common control, but are not consolidated in the financial statements presented.

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Question 7.2.270 Is a parent's guarantee of its subsidiary's debt excluded from Topic 460's scope after the subsidiary is spun off or otherwise deconsolidated?

Background: A spinoff is a transfer of assets that constitute a business by an entity (the spinnor) into a new legal spun-off entity (the spinnee), followed by a distribution of the shares of the spinnee to its shareholders, without the surrender by the shareholders of any stock of the spinnor. [505-60 Glossary]

Interpretive response: No. Following a spinoff (or other deconsolidation), the guarantee is no longer between entities under common control or a guarantee of the parent's own performance. Instead, at that time, the guarantee is effectively a new guarantee provided to a third party (the lender) related to the performance under a debt obligation of another third party (the former subsidiary).

Therefore, after the spinoff, the guarantee does not qualify for the scope exception for entities under common control or for the scope exception for guarantees of an entity's own performance (see Question 7.2.260). This means that it is subject to all provisions of Topic 460 starting on the date of the spinoff unless another scope exception applies. This guidance is consistent with views provided by the SEC staff. [2007 AICPA Conf]

Recognizing the guarantee

If a guarantee liability becomes subject to Topic 460 as a result of a spinoff or other deconsolidation, the guarantor (the former parent) initially recognizes and measures it on the date of the spinoff based on the guidance in section 7.3.

We believe the offsetting entry is generally recorded directly in the guarantor's equity as part of the distribution of nonmonetary assets to owners. However, depending on facts and circumstances, it may be acceptable to record the offsetting entry as an expense.

The guarantor discloses the guarantee (see section 7.7) and how it is reflected in the financial statements. Additionally, any change in the guarantee liability after initial recognition is recorded in the guarantor's income statement.

Question 7.2.280 Is a guarantee obligation settled in a guarantor's shares excluded from Topic 460's recognition and measurement provisions?

Excerpt from ASC 460-10

General

• > Scope Guidance—Guarantees that Are Not Subject to the General Subsections of the Recognition and Initial Measurement Sections of this Topic

55-19 The following is an example of a contract that is not subject to the General Subsections of Sections 460-10-25 and 460-10-30 because it is of one

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of the types described in paragraph 460-10- 25-1. The contract is subject to the General Subsection of Section 460-10-50.

55-20 If a guarantee contract stipulates that the guarantor's payment, if required, can be in the form of the guarantor's own equity shares at the guarantor's option, that obligation may, depending on the arrangements of the contract, be considered to be equity rather than a liability and, if so, the guarantee contract meets the characteristic in paragraph 460-10-25-1(d). To determine if a contract would be considered equity or a liability, see Topic 480 and Topic 505. See paragraph 460-10-55-24 if the guarantor's shares are placed in a trust or in some other similar arrangement to facilitate performance under the guarantee.

• > Recognition and Measurement Guidance—Collateral Arrangements

55-24 Under some arrangements, a loss under a guarantee is settled by the guarantor's issuing a variable number of its own equity shares. Those arrangements are often called share-trust or share-collateral transactions, whereby some specified number of the guarantor's shares is put in a trust or in some other similar arrangement to facilitate performance under the guarantee. The use of collateral arrangements under that guarantee does not change the accounting for the guarantee; thus, those arrangements are subject to the recognition, measurement, and disclosure requirements of this Topic and Topic 450. See paragraph 460-10-55-20 for additional scope guidance. Furthermore, those arrangements also could affect the calculation of earnings per share (EPS) under Topic 260 and disclosures thereunder.

Interpretive response: An entity's guarantee of the value of an asset, liability or equity security of another entity may require or permit settlement in the guarantor's equity shares (see Question 7.2.30). Whether it is subject to a scope exception from Topic 460 depends on whether it is a derivative and, if not, whether it is otherwise classified in equity, as summarized in the table below. This is the case even if the shares are used to collateralize the guarantee. [460-10-55-20, 55-24]

Equity or liability guarantee	Applicable Topic 460 scope exception
Guarantee is accounted for as a derivative under Topic 815	If the guarantee is a credit derivative, it is excluded from *all* of Topic 460's provisions (see Question 7.2.210). Otherwise, it is excluded only from the recognition and measurement provisions of Topic 460 (see Question 7.2.250). [460-10-25-1(d)] See chapters 2 and 3 of KPMG Handbook, Derivatives and hedging, about whether a guarantee is a derivative in Topic 815's scope.
Certain market value guarantees that are in the scope of Topic 480 (a guarantee of the value of an asset, liability or equity security of another entity that requires or permits settlement in the guarantor's shares and does not qualify as a derivative)	A guarantor accounts for its obligation to stand ready to perform (noncontingent aspect) under Topic 460 and accounts for a conditional obligation to issue equity shares under Topic 480 (contingent aspect). [460-10-25-1(d), 480-10-55-23]

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Equity or liability guarantee	Applicable Topic 460 scope exception
	See section 7.3 for an overview of the noncontingent and contingent aspects of guarantees. See Question 6.6.60 and Example 6.6.90 of KPMG Handbook, Debt and equity financing, for specific discussion and illustration of the accounting for certain market value guarantees.
Guarantee is classified in equity (i.e. is not liability classified under Topic 480 or Subtopic 815-40)	The guarantee is excluded from the recognition and measurement provisions in Topic 460. [460-10-25-1(d)] See chapters 6 and 8 of KPMG Handbook, Debt and equity financing, for guidance about the scopes of Topic 480 and Subtopic 815-40.

7.3 Guarantees: Recognition and measurement overview

Excerpt from ASC 460-10

General

25-2 The issuance of a guarantee obligates the guarantor (the issuer) in two respects:

a. The guarantor undertakes an obligation to stand ready to perform over the term of the guarantee in the event that the specified triggering events or conditions occur (the noncontingent aspect).
b. The guarantor undertakes a contingent obligation to make future payments if those triggering events or conditions occur (the contingent aspect).

For guarantees that are not within the scope of Subtopic 326-20 on financial instruments measured at amortized cost, no bifurcation and no separate accounting for the contingent and noncontingent aspects of the guarantee are required by this Topic. For guarantees that are within the scope of Subtopic 326-20, the expected credit losses (the contingent aspect) shall be measured and accounted for in addition to and separately from the fair value of the guarantee (the noncontingent aspect) in accordance with paragraph 460-10-30-5.

25-3 Because the issuance of a guarantee imposes a noncontingent obligation to stand ready to perform in the event that the specified triggering events or conditions occur, the provisions of Section 450-20-25 regarding a guarantor's contingent obligation under a guarantee should not be interpreted as prohibiting a guarantor from initially recognizing a liability for a guarantee even though it is not **probable** that payments will be required under that guarantee. Similarly, for guarantees within the scope of Subtopic 326-20, the requirement

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to measure a guarantor's expected credit loss on the guarantee should not be interpreted as prohibiting a guarantor from initially recognizing a liability for the noncontingent aspect of a guarantee.

25-4 At the inception of a guarantee, a guarantor shall recognize in its statement of financial position a liability for that guarantee. This Subsection does not prescribe a specific account for the guarantor's offsetting entry when it recognizes a liability at the inception of a guarantee. That offsetting entry depends on the circumstances in which the guarantee was issued. See paragraph 460-10-55-23 for implementation guidance.

A guarantee consists of a noncontingent and a contingent component. Noncontingent components are initially measured at fair value and subsequently measured to reflect the release from risk. Contingent components are measured differently, both initially and subsequently, depending on whether the guarantee is either:

- also in the scope of Subtopic 326-20; or
- a market value guarantee in the scope of Topic 480.

Contingent components that are neither of the above are initially and subsequently measured based on the guarantor's accounting policy election to account for the guarantee as one or two liabilities.

As discussed in section 7.1, Topic 460 provides separate scoping, recognition and measurement guidance for product warranties as compared to other guarantees. This section addresses recognition and measurement for guarantees other than product warranties and section 7.6 addresses recognition and measurement for product warranties.

Question 7.3.10 What are the components of a guarantee liability?

Interpretive response: At inception of a guarantee, the guarantor recognizes a liability on its balance sheet. The guarantor's liability represents the guarantor's obligation to: [460-10-25-2]

- stand ready to perform over the term of the guarantee (i.e. the noncontingent component); and
- make future payments contingent on a future triggering event or condition (i.e. the contingent component).

Even if the probability threshold under Subtopic 450-20 (see section 3.3.30) to recognize contingent losses related to the guarantee is not met, Topic 460 requires a guarantor to recognize a liability for that obligation. This is because the guarantor has an ongoing obligation to stand ready to perform. Further, the guidance in Subtopic 326-20 does not exempt a guarantor from initially recognizing the noncontingent component of a guarantee even though the contingent component is also separately recognized. [460-10-25-3]

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Question 7.3.20 How is a guarantee initially recognized and measured?

Excerpt from ASC 460-10

General

> Guarantees Not within the Scope of Subtopic 326-20

30-3 In the event that, at the inception of the guarantee, the guarantor is required to recognize a liability under Section 450-20-25 for the related contingent loss, the liability to be initially recognized for that guarantee shall be the greater of the following:

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.

> Guarantees within the Scope of Subtopic 326-20

30-5 At the inception of a guarantee within the scope of Subtopic 326-20 on financial instruments measured at amortized cost, the guarantor is required to recognize both of the following as liabilities:

a. The amount that satisfies the fair value objective in accordance with paragraph 460-10-30-2.
b. The contingent liability related to the expected credit loss for the guarantee measured under Subtopic 326-20.

Interpretive response: A guarantor recognizes a liability at inception of a guarantee in Topic 460's scope. Its initial measurement depends on whether the guarantee is either (a) also in the scope of Subtopic 326-20 or (b) a market value guarantee in the scope of Topic 480. In all cases, the noncontingent component of a guarantee is initially recognized and measured at fair value. In addition, a guarantor may also need to recognize an amount related to the guarantee's contingent component. [460-10-25-4]

Guarantee contract scope	Initial recognition and measurement
Guarantees that are *neither*: • **in the scope of Subtopic 326-20; nor** • **market value guarantees in the scope of Topic 480**	Initially recognized at the greater of the noncontingent and contingent component. The measurement of each component is as follows. [460-10-30-3] • **Noncontingent component:** Measured at fair value (see section 7.4.20). • **Contingent component:** Measured under the loss contingency guidance in Subtopic 450-20 (see section 7.5.30).
Guarantees that are *either*: • **also in the scope of Subtopic 326-20; or**	The noncontingent and contingent components are separately recognized. The measurement of each component is as follows. [460-10-30-5] • **Noncontingent component:** Measured at fair value (see section 7.4.20).

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Guarantee contract scope	Initial recognition and measurement
• **market value guarantees in the scope of Topic 480**	• **Contingent component:** Measured under the following guidance, as applicable: — expected credit loss guidance in Subtopic 326-20 (see section 7.5.20); or — measurement guidance in Topic 480 (see Question 7.2.280).

See Question 7.5.20 about which guarantees are in the scope of Subtopic 326-20 and Question 7.2.280 about certain market value guarantees in the scope of Topic 480.

Question 7.3.30 How do the contingent and noncontingent components of a guarantee interact after initial measurement?

Interpretive response: It depends on whether the guarantee is either of the following and, if not, it depends on the guarantor's accounting policy:

- also in the scope of Subtopic 326-20; or
- a market value guarantee in the scope of Topic 480.

These considerations are summarized in the following table.

Guarantee contract scope	Subsequent interaction
Guarantees that are *neither*: • **also in the scope of Subtopic 326-20; nor** • **market value guarantees in the scope of Topic 480**	We believe a guarantor may make an accounting policy election, consistently applied, to subsequently account for the noncontingent and contingent components as either separate liabilities or as a single (combined) liability. Even if a guarantor elects to measure the noncontingent and contingent components as a single liability, the guarantor will need to track each component separately under the applicable measurement guidance. This is because the guarantor recognizes the greater of the contingent and noncontingent components at each reporting period, as explained in Question 7.3.40.
Guarantees that are *either*: • **also in the scope of Subtopic 326-20; or** • **market value guarantees in the scope of Topic 480**	The guarantor is required to account for the noncontingent and contingent components separately. [460-10-30-5, 480-10-55-23]

See Question 7.5.20 about which guarantees are in the scope of Subtopic 326-20 and Question 7.2.280 about market value guarantees in the scope of Topic 480.

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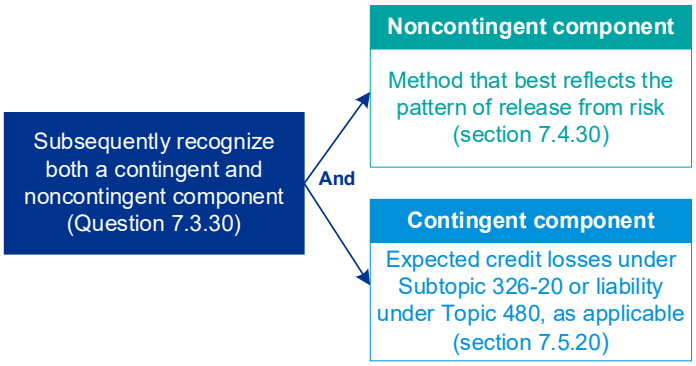
Question 7.3.40 How is a guarantee subsequently measured?

Interpretive response: It depends on whether the guarantee is either of the following and, if not, it depends on the guarantor's accounting policy:

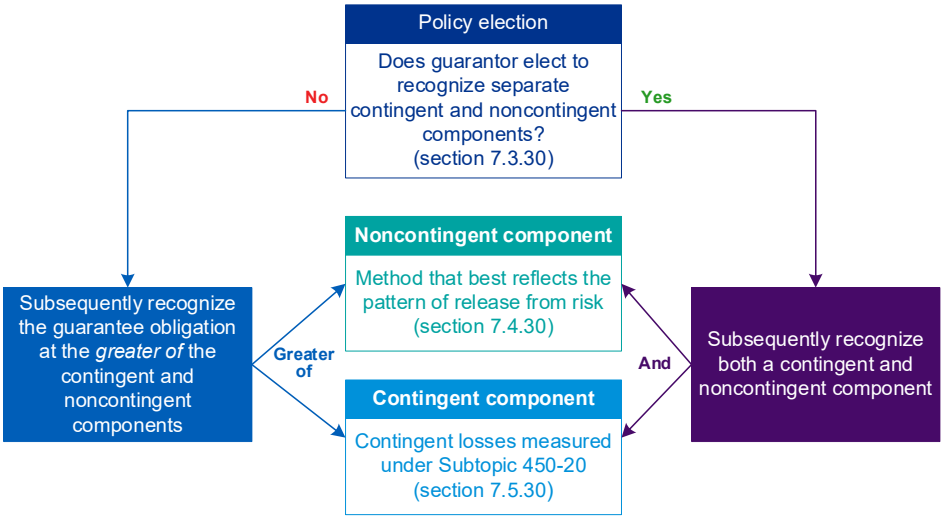
- also in the scope of Subtopic 326-20 (see Question 7.5.20); or
- a market value guarantee in the scope of Topic 480 and, if not, on the guarantor's accounting policy (see Question 7.2.280).

These considerations are summarized in the following decision trees. [460-10-25-2]

Subsequent measurement when guarantee is also in the scope of Subtopic 326-20 or is a market value guarantee in the scope of Topic 480



Subsequent measurement when guarantee is neither also in the scope of Subtopic 326-20 nor a market value guarantee in the scope of Topic 480



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7.4 Guarantees: Noncontingent component

7.4.10 Overview

This section addresses recognition and measurement of the noncontingent component of a guarantee (other than a product warranty) that is subject to Topic 460's recognition and measurement provisions. The guidance in this section applies regardless of whether the guarantee is also in the scope of Subtopic 326-20 or Topic 480.

For all guarantees subject to Topic 460's recognition and measurement provisions, the guarantor recognizes a liability for the fair value of the noncontingent (stand-ready) component at the guarantee's inception. A guarantor typically subsequently measures the noncontingent component by reducing the liability (by a credit to earnings) as it is released from risk under the guarantee. [460-10-25-4, 35-1]

Section 7.5 addresses recognition and measurement of the contingent component.

7.4.20 Initial measurement

The noncontingent component of the guarantee liability is initially measured at fair value. [460-10-30-2]

Question 7.4.10 How does a guarantor measure the initial fair value of the noncontingent component of a guarantee?

Excerpt from ASC 460-10

General

> Fair Value Objective

30-2 Except as indicated in paragraphs 460-10-30-3 through 30-5, the objective of the initial measurement of a guarantee liability is the fair value of the guarantee at its inception. For example:

a. If a guarantee is issued in a standalone arm's-length transaction with an unrelated party, the liability recognized at the inception of the guarantee shall be the premium received or receivable by the guarantor as a practical expedient.
b. If a guarantee is issued as part of a transaction with multiple elements with an unrelated party (such as in conjunction with selling an asset), the liability recognized at the inception of the guarantee should be an estimate of the guarantee's fair value. In that circumstance, a guarantor shall consider what premium would be required by the guarantor to issue the same

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guarantee in a standalone arm's-length transaction with an unrelated party as a practical expedient.

c. If a guarantee is issued as a contribution to an unrelated party, the liability recognized at the inception of the guarantee shall be measured at its fair value, consistent with the requirement to measure the contribution made at fair value, as prescribed in Section 720-25-30. For related implementation guidance, see paragraph 460-10-55-14.

• > Recognition and Measurement Guidance—Overall Guidance

55-21 In many cases, the one-time premium received by a guarantor for issuing a guarantee will be an appropriate practical expedient for the initial measurement of the guarantee obligation (see paragraph 460-10-30-2[a]). However, if a one-time premium is specified for a guarantee that is issued in conjunction with another transaction (such as the sale of assets by the guarantor), the specified premium may not be an appropriate initial measurement of the guarantor's liability because the amount specified as being applicable to the guarantee may or may not be its fair value (see paragraph 460-10-30-2[b]).

55-22 In accordance with paragraph 460-10-30-2, a liability shall be recognized at the inception of the guarantee even if the guarantor does not receive a separately identified premium when it issues the guarantee. For example, in conjunction with the cash sale of equipment to a customer, a manufacturer may issue to its customer's bank a guarantee of the customer's loan for which the proceeds are used to pay for the equipment. There is no separately identified premium for the guarantee, although the sales arrangement may impound an implicit premium. The manufacturer may simply view the guarantee as an accommodation to its customer. The seller-guarantor has incurred an obligation identical to the obligation it would incur if it required its customer to pay an explicit premium for the guarantee. Thus, the seller-guarantor shall immediately recognize a liability for its obligations under a newly issued guarantee, even if a separately identified premium was not received. If an entity guaranteed a customer's bank loan purely as an accommodation to an important longstanding customer, unrelated to a specific transaction, the liability for the entity's obligations under the guarantee should be recognized.

Background: Under Topic 820, fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The transaction price paid for the asset (or received to assume the liability) normally reflects an entry price, while Topic 820 requires fair value measurement to be based on an exit price. Although conceptually different, in many cases the exit and entry price are equal and therefore fair value at initial recognition generally equals the transaction price. However, the transaction price might not represent fair value at initial recognition depending on factors specific to the transaction and to the asset or liability.

Interpretive response: The guarantor measures a liability for the noncontingent (i.e. stand-ready) component at its fair value under the guidance in Topic 820. This liability is recognized even in the following situations: [460-10-30-2, 55-22]

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- there is a remote likelihood that the guarantor will be required to perform under the guarantee;
- no premium is explicitly received for the guarantee (whether in a stand-alone or a multiple element transaction); and/or
- the guarantee is issued as a contribution to an unrelated party.

However, as a practical expedient, a guarantor can initially recognize a guarantee for the premium received or receivable at the guarantee's inception (i.e. the transaction price/entry price) without evaluating whether it represents fair value under Topic 820 if: [460-10-30-2(a)]

- the guarantee is issued in a stand-alone arm's-length transaction; and
- the guarantee is issued to an unrelated party.

In all other situations, a guarantor determines fair value based on the guidance in Topic 820. For example, when a one-time premium is specified for a guarantee issued in conjunction with another transaction (such as a sale of assets by the guarantor), the first condition of the practical expedient is not met and the amount specified as being the premium for the guarantee cannot be presumed to be its fair value. [460-10-55-21]

Measuring the fair value of the stand-ready obligation may require significant judgment. See section F of KPMG Handbook, Fair value measurement, for guidance on measuring fair value at initial recognition.

Question 7.4.20 What is the offsetting entry when initially recognizing a guarantee liability?

Excerpt from ASC 460-10

• > Recognition and Measurement Guidance – Overall Guidance

55-23 Although paragraph 460-10-25-4 does not prescribe a specific account, the following illustrate a guarantor's offsetting entries when it recognizes the liability at the inception of the guarantee:

a. If the guarantee were issued in a standalone transaction for a premium, the offsetting entry would be consideration received (such as cash or a receivable).
b. If the guarantee were issued in conjunction with the sale of assets, a product, or a business, the overall proceeds (such as the cash received or receivable) would be allocated between the consideration being remitted to the guarantor for issuing the guarantee and the proceeds from the sale. That allocation would affect the calculation of the gain or loss on the sale transaction.
c. If the guarantee were issued in conjunction with the formation of a partially owned business or a venture accounted for under the equity method, the recognition of the liability for the guarantee would result in an increase to the carrying amount of the investment.
d. …

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e. If a guarantee were issued to an unrelated party for no consideration on a standalone basis (that is, not in conjunction with any other transaction or ownership relationship), the offsetting entry would be to expense.

• • > Lessee Tax Indemnification

55-23A This implementation guidance addresses the application of this Subtopic to the recognition and initial measurement of a tax indemnification provided by a lessee to a lessor. Paragraph 460-10-25-4 requires that the lessee (guarantor) account for a tax indemnification provided to the lessor by recognizing a liability at lease inception (which is also the inception of the indemnification clause). Section 460-10-30 requires that the measurement objective of that initial recognition be the fair value of the lessee's obligation under the indemnification agreement.

Interpretive response: Topic 460 does not prescribe a specific offsetting entry in the initial recognition of the guarantee liability. However, it indicates that the offsetting entry depends on the circumstances surrounding the guarantee's issuance and provides several examples. [460-10-25-4]

The following illustrate the offsetting entries when a guarantor recognizes a liability at the guarantee's inception.

Circumstance	Offsetting entry for guarantee
Guarantee issued in a stand-alone transaction for a premium that is considered its fair value [460-10-55-23(a)]	Asset for consideration received (e.g. cash, accounts receivable)
Guarantee issued to an unrelated party in conjunction with sale of assets, product or business [460-10-55-23(b)]	Total consideration received (e.g. cash, accounts receivable) allocated between the guarantee and sale, affecting the gain or loss on the sale
Guarantee issued to an unrelated party in conjunction with formation of an investee accounted for under the equity method (e.g. partially owned business or venture) [460-10-55-23(c)]	Increase in the carrying amount of the investment under Topic 323 (investments – equity method and joint ventures)
Guarantee issued to an unrelated party for no consideration on a stand-alone basis (i.e. not in conjunction with any other transaction or ownership relationship) [460-10-55-23(e)]	Expense
Guarantee issued to a related party that is not under common control	To the extent a guarantor recognizes a noncontingent or contingent liability, we believe the guarantor should consider whether to reflect the offsetting entry (or a portion thereof) as (a) compensation expense, (b) additional investment in the related party or (c) a reduction of shareholders' equity.

Topic 460 does not explicitly address the offsetting entry for all guarantors. In other situations, guarantors need to apply judgment in determining the appropriate offsetting entry based on the nature of the underlying transaction.

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7.4.30 Subsequent measurement

Excerpt from ASC 460-10

General

35-1 This Subsection does not describe in detail how the guarantor's liability for its obligations under the guarantee would be measured after its initial recognition. The liability that the guarantor initially recognized under paragraph 460-10-25-4 would typically be reduced (by a credit to earnings) as the guarantor is released from risk under the guarantee.

35-2 Depending on the nature of the guarantee, the guarantor's release from risk has typically been recognized over the term of the guarantee using one of the following three methods:

a. Only upon either expiration or settlement of the guarantee
b. By a systematic and rational amortization method
c. As the fair value of the guarantee changes.

Although those three methods are currently being used in practice for subsequent accounting, this Subsection does not provide comprehensive guidance regarding the circumstances in which each of those methods would be appropriate. A guarantor is not free to choose any of the three methods in deciding how the liability for its obligations under the guarantee is measured subsequent to the initial recognition of that liability. A guarantor shall not use fair value in subsequently accounting for the liability for its obligations under a previously issued guarantee unless the use of that method can be justified under generally accepted accounting principles (GAAP). For example, fair value is used to subsequently measure guarantees accounted for as derivative instruments under Topic 815.

Question 7.4.30 How is the noncontingent component of a guarantee subsequently measured?

Interpretive response: Topic 460 does not provide prescriptive guidance on subsequent measurement of the noncontingent component of a guarantee. However, it indicates that a guarantor typically reduces the liability (by a credit to earnings) as the guarantor is released from risk under the guarantee and describes three methods that are typically used. A guarantor uses the method that best reflects the pattern of release from risk based on the facts and circumstances related to the individual guarantee. [460-10-35-1]

We believe the method used to account for the noncontingent (i.e. stand-ready) component of a guarantee should be used consistently. Following are examples of methods that may reflect the pattern of release from risk depending on the facts and circumstances: [460-10-35-2]

- upon expiration or settlement;
- by systematic and rational amortization method; or

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- as the fair value of the guarantee changes (subsequent measurement at fair value with changes reported in earnings is only permitted if allowable under other US GAAP; see Question 7.4.40).

See KPMG Handbook, Fair value measurement, for guidance about measuring fair value.

Example 7.4.10 Subsequent adjustment of tax indemnification liability

In connection with ABC Corp's sale of Subsidiary, ABC agreed to indemnify Acquirer for all tax liabilities (including income, value added and other taxes) for matters arising before the sale closes. Because ABC no longer owns Subsidiary, ABC's obligation is to Acquirer and not that of a taxpayer, so Topic 740 does not apply to the tax indemnification obligation.

ABC concludes that the tax indemnification is not a derivative liability under Topic 815 and also that it is a guarantee under Topic 460. Further, at inception, ABC concludes that any contingent losses measured under Subtopic 450-20 would not exceed the guarantee's fair value (see Question 7.5.40). Therefore, ABC recognizes a guarantee liability for the fair value of the indemnification agreement at its inception.

Due to the nature of the tax indemnities, which include certain expiration dates of audit and examination periods, ABC accounts for the noncontingent component by subsequently reducing the liability upon either expiration or settlement of the tax indemnification.

ABC elects to subsequently account for the contingent and noncontingent components as a single liability (see Question 7.3.30). As a result, the one combined liability is measured after initial recognition at the greater of:

- the initially recognized fair value of the stand-ready portion of the tax indemnification as reduced for expirations or settlements of the tax indemnification (see Question 7.4.30); or
- the amount determined under Subtopic 450-20 (see Question 7.5.50).

Question 7.4.40 May a guarantor use fair value as the subsequent measurement attribute for a guarantee?

Interpretive response: Topic 460 only permits a guarantor to use fair value as a subsequent measurement attribute if it is permitted or required under other US GAAP. [460-10-35-2]

For example, certain guarantees are eligible for the fair value option under Subtopic 825-10 (see Question 6.2.130 of KPMG Handbook, Investments). In that case, a guarantor can make a one-time irrevocable policy election at the guarantee's inception to measure it both initially and subsequently at fair value under Subtopic 825-10.

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In addition, the SEC staff's longstanding position is that written options that do not qualify for equity classification are both initially and subsequently measured at fair value, with changes in fair value included in earnings. The SEC staff has clarified that its longstanding position does not apply to written options qualifying as guarantees and that guarantees should not be subsequently measured at fair value by analogy to Topic 815 for instruments not in Topic 815's scope. [815-10-S99-4, 2003 AICPA Conf]

7.5 Guarantees: Contingent component

7.5.10 Overview

This section addresses recognition and measurement of the contingent component of a guarantee (other than a product warranty) that is subject to Topic 460's recognition and measurement provisions.

Question 7.5.10 How does a guarantor initially and subsequently measure the contingent component of a guarantee?

Interpretive response: It depends on whether the guarantee is also in the scope of Subtopic 326-20 (see Question 7.5.20) or a market value guarantee in the scope of Topic 480 (see Question 7.2.280), as summarized in the following table.

Guarantee contract scope	Initial and subsequent measurement
Guarantees that are *neither:* • **also in the scope of Subtopic 326-20; nor** • **certain market value guarantees in the scope of Topic 480**	The contingent component of the guarantee is measured based on the loss contingency guidance of Subtopic 450-20 both initially and subsequently. While Topic 460 does not provide specific guidance on the interaction between the contingent and noncontingent components, we believe a guarantor establishes an accounting policy about whether they recognize one combined or two separate liabilities (see Question 7.3.30). Even if a guarantor elects to measure the noncontingent and contingent components as a single liability, the guarantor will need to track each component separately under the applicable measurement guidance. This is because the guarantor recognizes the greater of the contingent and noncontingent components at each reporting period, as explained in Question 7.3.40. See section 7.5.30 for additional discussion.
Guarantees that are *either*: • **also in the scope of Subtopic 326-20; or**	The contingent component of the guarantee is accounted for separately from (i.e. in addition to) the noncontingent component. It is measured under Subtopic 326-20's expected credit loss model or Topic

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Guarantee contract scope	Initial and subsequent measurement
• **certain market value guarantees in the scope of Topic 480**	480's measurement guidance, as applicable, both initially and subsequently. See section 7.5.20 for discussion about guarantees also in the scope of Subtopic 326-20 and Question 7.2.280 for discussion about market value guarantees in the scope of Topic 480.

Section 7.4 addresses recognition and measurement of the noncontingent component.

7.5.20 Guarantees also in scope of Subtopic 326-20

Excerpt from ASC 460-10

General

45-1 Paragraph 825-10-35-1 states that an accrual for credit loss on a financial instrument with off-balance-sheet risk (including financial guarantees and **financial standby letters of credit**) shall be recorded separate from a valuation account related to a recognized financial instrument and provides related guidance.

Question 7.5.20 What type of guarantees are in the scope of Subtopic 326-20?

Interpretive response: Guarantees that create off-balance sheet credit exposure, but are not accounted for as either derivatives or insurance, are in the scope of Subtopic 326-20. We believe that guarantees create off-balance sheet credit exposure if they require the guarantor to make a payment due to a failure of another party to satisfy its required payment obligation. [326-20-15-2(c)]

Guarantees that may be in the scope of Subtopic 326-20 include:

- a franchisor's guarantee of a franchisee's lease obligation;
- a standby letter of credit issued by a financial institution;
- an investor's guarantee of an investee's debt obligation; and
- a manufacturer's guarantee of a customer loan used to finance the purchase of goods from the manufacturer.

However, a guarantee of an entity's own performance or its own obligation, including a parent's guarantee of the performance of a consolidated subsidiary (from the perspective of the consolidated financial statements), is not in the scope of Subtopic 326-20.

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Question 7.5.30 How is the contingent component of a guarantee that is also in the scope of Subtopic 326-20 measured?

Interpretive response: A separate liability for off-balance sheet credit risk is recognized under Subtopic 326-20 for expected credit losses related to the contingent component. The FASB decided that this approach was necessary to appropriately present expected credit losses on guarantees without affecting the fee recognition that results from the accounting for the noncontingent component. [460-10-25-3, 30-5, 45-1, ASU 2016-13.BC97]

Measurement of the guarantee liability for the contingent component of the guarantee is determined under Subtopic 326-20, both initially and subsequently. At each reporting date, a guarantor estimates expected credit losses and adjusts the liability for off-balance sheet credit losses through earnings.

See chapter 14 of KPMG Handbook, Credit impairment, for guidance about recognition and measurement of the contingent component under Subtopic 326-20.

7.5.30 Other guarantees in the scope of Topic 460

Question 7.5.40 How is the contingent component of a guarantee that is not in the scope of Subtopic 326-20 or Topic 480 initially measured?

Excerpt from ASC 460-10

General

> Guarantees Not within the Scope of Subtopic 326-20

30-4 For many guarantors, it would be unusual at the inception of the guarantee for the contingent liability amount under (b) in the preceding paragraph to exceed the amount that satisfies the fair value objective under (a) in the preceding paragraph. An example of that unusual circumstance is a guarantee for which, at inception, there is a high (**probable**) likelihood that the guarantor will be required to pay the maximum potential settlement at the end of the six-month term and a low likelihood that the guarantor will not be required to make any payment at the end of the six-month term. The amount that satisfies the fair value objective would include consideration of the low likelihood that no payment will be required, but the accrual of the contingent loss under Section 450-20-30 would be based solely on the best estimate of the settlement amount whose payment is probable (the maximum potential settlement amount in this case). This example is considered to be an unusual circumstance because of the high likelihood at inception that the maximum potential settlement amount will be paid, resulting in a substantial initial fair value for that guarantee. Another example in which the contingent liability

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amount required to be recognized under (b) in the preceding paragraph exceeds the fair value at inception under (a) in the preceding paragraph would involve an undiscounted accrual under Subtopic 450-20 for a guarantee payment that is expected to occur many years in the future.

Interpretive response: The contingent component of a guarantee that is not also in the scope of Subtopic 326-20 or Topic 480 is recognized at inception of the guarantee only to the extent any contingent loss measured under Subtopic 450-20 (see section 4.3) exceeds the guarantee's fair value. [460-10-30-3(b), 460-10-35-4]

At the inception of such a guarantee, it would be unusual for the contingent component (measured under Subtopic 450-20) to be greater than the fair value of the noncontingent component. This is because a guarantor would usually charge a premium commensurate with the amount of risk incurred (which is reflected in the measurement of the guarantee's noncontingent component) and that premium would consider an amount that is probable to be paid under the guarantee arrangement as of its inception date. [460-10-30-4]

Question 7.5.50 How is the contingent component of a guarantee that is not in the scope of Subtopic 326-20 or Topic 480 subsequently measured?

Excerpt from ASC 460-10

General

35-4 The discussion in paragraph 460-10-35-2 about how a guarantor typically reduces the liability that it initially recognized does not encompass the recognition and subsequent adjustment of the contingent liability related to the contingent loss for the guarantee. The contingent aspect of the guarantee shall be accounted for in accordance with Subtopic 450-20 unless the guarantee is accounted for as a derivative instrument under Topic 815 or the guarantee is within the scope of Subtopic 326-20 on financial instruments measured at amortized cost. For guarantees within the scope of Subtopic 326-20, the expected credit losses (the contingent aspect) of the guarantee shall be accounted for in accordance with that Subtopic in addition to and separately from the fair value of the guarantee liability (the noncontingent aspect) accounted for in accordance with paragraph 460-10-30-5.

Interpretive response: A guarantor subsequently measures the contingent component of a guarantee that is not in the scope of Subtopic 326-20 or Topic 480 based on the loss contingency guidance in Subtopic 450-20 (see section 4.3 for guidance on measuring that amount). However, how much of the amount measured under Subtopic 450-20 is recognized depends on whether the guarantor elects to account for the contingent and noncontingent components separately or as a single (combined) liability: [460-10-35-2, 460-10-35-4]

- **Single (combined) liability**: The guarantor records the contingent component's measurement under Subtopic 450-20 to the extent it exceeds

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the carrying amount of the noncontingent component recognized under Topic 460 (see section 7.4.30).

- **Two separate liabilities**: The guarantor records a separate liability for the contingent component's measurement under Subtopic 450-20. The noncontingent component is separately recognized and measured as discussed in section 7.4.30. This could result in an increase in earnings from subsequent measurement of the noncontingent component and a charge to earnings for the contingent loss component. [460-10-35-3, 460-10-35-4]

7.6 Product warranties

Topic 460 provides guidance in separate subsections for product warranties. This includes separate guidance for:

- scope (Questions 7.6.10 to 7.6.30);
- recognition and measurement (Questions 7.6.40 to 7.6.70), which differs between warranty obligations that:
  - provide the customer with a service in addition to the product's compliance with agreed-upon specifications (e.g. separately priced extended warranty or product maintenance contracts), also referred to as 'service-type' warranties; versus
  - only cover a product's or service's compliance with agreed-upon specifications incurred in connection with the sale of those goods or services, also referred to as 'assurance-type' warranties; and
- disclosures (section 7.7); Topic 460's general disclosures apply with some differences as explained in Question 7.7.30.

Question 7.6.10 What are product warranties under Topic 460?

Excerpt from ASC 460-10

Product Warranties

> Transactions

15-9 The guidance in the Product Warranties Subsections applies only to product **warranties**, which include all of the following:

a. Product warranties issued by the guarantor, regardless of whether the guarantor is required to make payment in services or cash
b. Separately priced extended warranty or product maintenance **contracts** and warranties that provide a **customer** with a service in addition to the assurance that the product complies with agreed-upon specifications (see paragraphs 606-10-55-30 through 55-35 for guidance on determining whether a warranty provides a customer with a service in addition to the assurance that the product complies with agreed-upon specifications)

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c. Warranty obligations that are incurred in connection with the sale of the product, that is, obligations in which the customer does not have the option to purchase the warranty separately and that do not provide the customer with a service in addition to the assurance that the product complies with agreed-upon specifications.

Background: Warranties are guarantees for which the underlying is related to the performance (regarding function, not price) of nonfinancial assets that are owned by the guaranteed party. The obligation may be incurred in connection with the sale of goods or services; if so, it may require further performance by the seller after the sale has taken place. [460-10 Glossary, 606-10-55-30]]

Interpretive response: Product warranties under Topic 460 include the following:

- separately priced extended warranty or product maintenance contracts and warranties that provide a customer with a service in addition to the assurance that the product complies with agreed-upon specifications; and
- warranty obligations incurred in connection with the sale of a product for which:
  - the customer does not have the option to purchase the warranty separately; and
  - the customer is not provided with a service in addition to the assurance that the product complies with agreed-upon specifications.

Product warranties issued by the guarantor are included in the scope of Topic 460 regardless of whether the guarantor is required to make payment in services or cash.

Question 7.6.20 How does the guidance for a product warranty differ when it represents a guarantee of the entity's own future performance versus its past performance?

Excerpt from ASC 460-10

Product Warranties

> Implementation Guidance

• > Performance Warranties

55-28 A representation by a manufacturer to its customer that a particular engine would produce a specified savings in its energy consumption qualifies for the scope exception in paragraph 460-10-25-1(b) because that representation relates to how efficiently the engine operates.

55-29 In contrast, a service provider's representation as to the quality of its services does not need to qualify for that scope exception because it is a

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guarantee of the service provider's (guarantor's) future performance and, as such, is excluded from the scope of this Topic by paragraph 460-10-15-7(i).

Interpretive response: An entity's guarantee of its own future performance is excluded from all of Topic 460's provisions (see Question 7.2.230). This means it is also excluded from the guidance for product warranties. [460-10-55-29]

There is no exception from all of Topic 460's provisions for guarantees of an entity's *past* performance. However, product warranties that are based on an entity's past performance are subject to the product warranties' recognition and measurement guidance (see Question 7.6.40) instead of Topic 460's *general* recognition and measurement guidance. [460-10-15-10, 55-28]

Question 7.6.30 Do intellectual property infringement indemnifications represent product warranties?

Excerpt from ASC 460-10

Product Warranties

> Illustrations

• > Example 1: Licensee Indemnifications

55-31 As an element of its standard commercial terms, a software vendor-licensor includes an indemnification clause in a software licensing agreement that indemnifies the licensee against liability and damages (including legal defense costs) arising from any claims of patent, copyright, trademark, or trade secret infringement by the software vendor's software. That indemnification arrangement constitutes a guarantee that is not subject to the recognition requirements or the initial measurement requirements of the General Subsections of Sections 460-10-25 or 460-10-30, respectively.

55-32 That arrangement exhibits the characteristic in paragraph 460-10-15-4(c): the indemnification obligates the seller-licensor (guarantor) to make a payment to the buyer-licensee (guaranteed party) based on changes in an **underlying** related to the software license (an asset of the guaranteed party). In this situation, the underlying is the occurrence of an infringement claim against the licensee that results in any liabilities or damages related to the licensed software (the asset) of the licensee (the indemnified party).

55-33 Nonetheless, because a possibility exists, regardless of how remote, that an infringement claim covered by the indemnification could impair the licensee's ability to use the licensed software (for example, if an injunction is issued or the claim is ultimately proven), the underlying is also related to the performance (regarding function, not price) of that licensed software—that is, the licensed software cannot function as intended until the seller-licensor cures the alleged infringement defect. Thus, the arrangement qualifies for the scope exception in paragraph 460-10-25-1(b).

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55-34 However, it would be subject to the disclosure requirements of the General Subsection of Section 460-10-50, as well as the disclosure requirements specified in the Product Warranties Subsection of that Section.

Background: As an element of its standard commercial licensing contract, a software vendor-licensor includes an indemnification clause in a software licensing agreement that indemnifies the licensee against liability and damages (including legal defense costs) arising from claims of patent, copyright, trademark or trade secret infringement by the software vendor's software. [460-10-55-31]

Interpretive response: Yes. An intellectual property indemnification agreement represents a product warranty because a possibility exists – even if remote – that an infringement claim covered by the indemnification could impair the indemnified party's ability to use the licensed software. As such, the underlying is also related to the performance (function, not price) of that licensed software; that is, the licensed software cannot function as intended until the seller-licensor fixes the alleged infringement defect. [460-10-25-1(b), 460-10 Glossary]

Question 7.6.40 What recognition and measurement guidance applies to product warranties?

Excerpt from ASC 460-10

Product Warranties

> Separately Priced Extended Warranty or Product Maintenance Contracts

25-8 Topic 606 on **revenue** from **contracts** with **customers**, and specifically the guidance on warranties in paragraphs 606-10-55-30 through 55-35, provide guidance on revenue recognition by sellers of extended warranty or product maintenance contracts and warranties that provide a customer with a service in addition to the assurance that the product complies with agreed-upon specifications.

25-8A Paragraph 605-20-25-6 provides guidance on recognizing a loss on separately priced extended warranty and product maintenance contracts.

Interpretive response: It depends on the type of product warranty, as summarized in the following table.

Product warranty type (see Question 7.6.50)	Applicable recognition and measurement guidance
Service-type warranties [460-10-25-8 – 25-8A]	• Topic 606 (revenue), including its guidance specific to warranties; see section 4.5 of KPMG Handbook, Revenue recognition. • Subtopic 605-20's guidance about recognizing a loss on separately priced extended warranty and product maintenance contracts. When an entity has a separate performance obligation under Topic 606 for a service-type warranty that is not separately priced, the loss recognition guidance in Subtopic 605-20 does not

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Product warranty type (see Question 7.6.50)	Applicable recognition and measurement guidance
	apply; see section 13.3 of KPMG Handbook, Revenue recognition.
Assurance-type warranties [460-10-25-5 – 25-7]	• Topic 460, which requires applying the loss contingency guidance in Subtopic 450-20, with incremental guidance provided in Topic 460 (see also Questions 7.6.50 to 7.6.70).

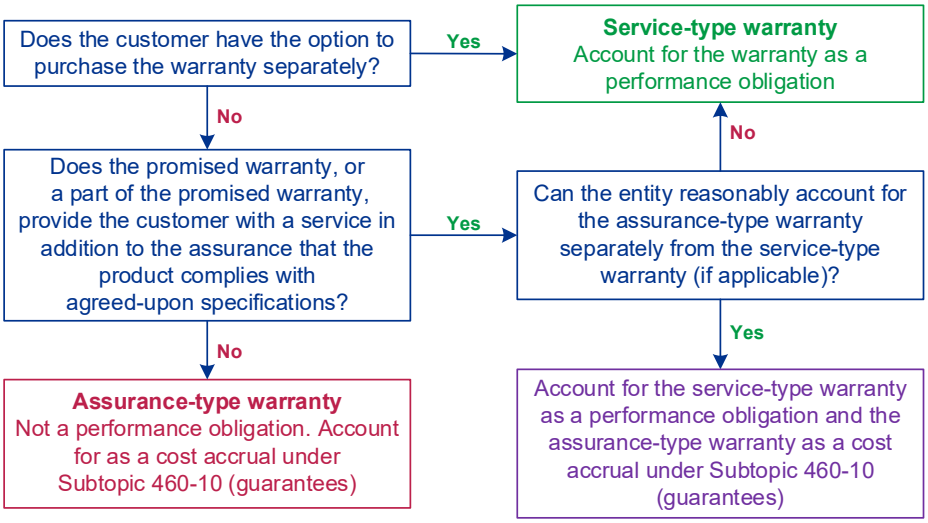
For all product warranties (including those for which the recognition and measurement guidance of Topic 606 applies), the disclosure guidance in Topic 460 applies (see Question 7.7.60). [460-10-15-9 – 15-10, 460-10-50-7 – 50-8]

Question 7.6.50 When is a product warranty considered assurance-type vs service-type?#

Interpretive response: An assurance-type warranty is one that provides assurance that the good or service sold will comply with agreed-upon specifications. A warranty that goes beyond this assurance is (or includes) a service-type warranty; these include:

- separately priced extended warranties or product maintenance contracts that the customer has the option to purchase; and [606-10-55-31]
- a promised warranty, or part of a promised warranty, that provides the customer with a service in addition to the assurance that the product complies with agreed-upon specifications. [606-10-55-32]

The following decision tree summarizes the key considerations in determining the type of product warranty and Question 7.6.60 provides additional information about how each is recognized and measured.



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Judgment may be required to properly distinguish between assurance- and service-type warranties, particularly when an entity does not sell the warranty separately. Factors that are considered include whether the warranty is required by law, the length of the warranty coverage period and the nature of the tasks that the entity promises to perform. [606-10-55-33]

In some situations, a single product warranty provides both an assurance-type and a service-type warranty. In this case, the entity typically accounts for those items separately. However, they would be accounted for together under Topic 606, as a single performance obligation, if the entity cannot reasonably account for them separately. [606-10-55-34]

See section 4.5 of KPMG Handbook, Revenue recognition, for further guidance on determining whether a warranty provides a customer with a service in addition to the assurance that the product complies with agreed-upon specifications.

Question 7.6.60 How are assurance-type warranty obligations recognized and measured?

Excerpt from ASC 460-10

Product Warranties

> Warranty Obligations Incurred in Connection with the Sale of Goods or Services

25-5 Because of the uncertainty surrounding claims that may be made under warranties, **warranty** obligations fall within the definition of a **contingency**. Losses from warranty obligations shall be accrued when the conditions in paragraph 450-20-25-2 are met.

25-6 The condition in paragraph 450-20-25-2(a) is met at the date of an entity's financial statements if, based on available information, it is **probable** that customers will make claims under warranties relating to goods or services that have been sold. Satisfaction of the condition in paragraph 450-20-25-2(b) will normally depend on the experience of an entity or other information. In the case of an entity that has no experience of its own, reference to the experience of other entities in the same business may be appropriate. Inability to make a reasonable estimate of the amount of a warranty obligation at the time of sale because of significant uncertainty about possible claims (that is, failure to satisfy condition [b] in that paragraph) precludes accrual and, if the range of possible loss is wide, may raise a question about whether a sale should be recorded before expiration of the warranty period or until sufficient experience has been gained to permit a reasonable estimate of the obligation.

Interpretive response: Because of the uncertainty surrounding claims that may be made under them (e.g. volume, amount, timing), assurance-type warranty obligations are loss contingencies that are recognized and measured when the criteria in Subtopic 450-20 are met. Topic 460 provides incremental guidance about whether an assurance-type warranty obligation meets these criteria.

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The following table summarizes the criteria under Subtopic 450-20 and the incremental guidance in Topic 460 in the context of assurance-type warranty obligations. [460-10-25-5 – 25-6]

Condition for accrual under paragraph 450-20-25-2 (see chapter 3)	Incremental guidance in Topic 460
Information available before the financial statements are issued or are available to be issued (as discussed in Topic 855) 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. [450-20-25-2(a)]	This condition is met if, based on available information at the balance sheet date, it is probable that customers will make claims under warranties relating to goods or services that have been sold (see also Question 7.6.70).
The amount of loss can be reasonably estimated. [450-20-25-2(b)]	An entity's ability to make a reasonable estimate will normally depend on its experience or other information. If an entity does not have any of its own historical experience, it may be appropriate to use the experience of other entities in the same business. If an entity cannot make a reasonable estimate of the amount of a warranty obligation at the time of sale, it does not recognize a loss accrual. Additionally, if the range of possible loss is wide, an entity considers whether revenue should be recognized before either: • expiration of the warranty period; or • sufficient experience has been gained to permit a reasonable estimate of the obligation.

See chapter 3 for Subtopic 450-20's loss contingencies guidance.

Question 7.6.70 Must an entity be able to identify which customer(s) are probable of making a warranty claim to accrue a warranty obligation?

Excerpt from ASC 460-10

Product Warranties

> Warranty Obligations Incurred in Connection with the Sale of Goods or Services

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25-7 The conditions in paragraph 450-20-25-2 may be considered in relation to individual sales made with warranties or in relation to groups of similar types of sales made with warranties. If those conditions are met, accrual shall be made even though the particular parties that will make claims under warranties may not be identifiable.

Interpretive response: Not necessarily. An entity does not need to identify a particular customer that may make a warranty claim in determining whether it is probable such a claim will be made. Warranty accruals may be made in relation to (a) individual sales made with warranties or (b) groups of similar types of sales made with warranties. [460-10-25-7]

7.7 Disclosure

Topic 460 contains general disclosure requirements that apply to guarantees and product warranties and disclosure requirements that apply only to product warranties.

Question 7.7.10 What guarantees and product warranties are subject to the general disclosure requirements in Topic 460?

Excerpt from ASC 460-10

General

> Information about Each Guarantee or Group of Similar Guarantees

• > Loss Contingencies

50-1 The requirements in paragraphs 460-10-50-2 through 50-4 apply to guarantees, including guarantees that are outside the scope of paragraph 460-10-15-4; however, they do not apply to guarantees described in paragraph 460-10-15-7.

Product Warranties

> Other Considerations

15-10 The guidance in the General Subsections of Sections 460-10-25 and 460-10-30 does not apply to guarantee contracts within the scope of the Product Warranties Subsections. Those guarantee contracts are subject, however, to the requirements in the General Subsection of Section 460-10-50

Interpretive response: The general disclosure requirements in Topic 460 apply to all guarantees and product warranties in the scope of Topic 460, including guarantees that are excluded from Topic 460's recognition and measurement provisions (see section 7.2.40). Guarantees that are entirely excluded from Topic 460 are not subject to its disclosure requirements (see section 7.2.30). [460-10-50-1, 460-10-15-10]

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Question 7.7.20 What general disclosures does Topic 460 require for guarantees and product warranties?

Excerpt from ASC 460-10

General

> Information about Each Guarantee or Group of Similar Guarantees

• > Loss Contingencies

50-2 An entity shall disclose certain **loss contingencies** even though the possibility of loss may be remote. The common characteristic of those contingencies is a guarantee that provides a right to proceed against an outside party in the event that the guarantor is called on to satisfy the guarantee. Examples include the following:

a. Guarantees of indebtedness of others, including **indirect guarantees of indebtedness** of others
b. Obligations of commercial banks under standby letters of credit
c. Guarantees to repurchase receivables (or, in some cases, to repurchase the related property) that have been sold or otherwise assigned
d. Other agreements that in substance have the same guarantee characteristic.

50-3 The disclosure shall include the nature and amount of the guarantee. Consideration should be given to disclosing, if estimable, the value of any recovery that could be expected to result, such as from the guarantor's right to proceed against an outside party.

• > Disclosures about a Guarantor's Obligation

50-4 A guarantor shall disclose all of the following information about each guarantee, or each group of similar guarantees, even if the likelihood of the guarantor's having to make any payments under the guarantee is remote:

a. The nature of the guarantee, including all of the following:
    1. The approximate term of the guarantee
    2. How the guarantee arose
    3. The events or circumstances that would require the guarantor to perform under the guarantee
    4. The current status (that is, as of the date of the statement of financial position) of the payment/performance risk of the guarantee (for example, the current status of the payment/performance risk of a credit-risk-related guarantee could be based on either recently issued external credit ratings or current internal groupings used by the guarantor to manage its risk)
    5. If the entity uses internal groupings for purposes of item (a)(4), how those groupings are determined and used for managing risk.
b. All of the following information about the maximum potential amount of future payments under the guarantee:
    1. The maximum potential amount of future payments (undiscounted) that the guarantor could be required to make under the guarantee, which shall not be reduced by the effect of any amounts that may

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possibly be recovered under recourse or collateralization provisions in the guarantee (which are addressed under (d) and (e))
2. If the terms of the guarantee provide for no limitation to the maximum potential future payments under the guarantee, that fact
3. If the guarantor is unable to develop an estimate of the maximum potential amount of future payments under its guarantee, the reasons why it cannot estimate the maximum potential amount.

c. The current carrying amount of the liability, if any, for the guarantor's obligations under the guarantee (including the amount, if any, recognized under Section 450-20-30 or Subtopic 326-20 on financial instruments measured at amortized cost), regardless of whether the guarantee is freestanding or embedded in another contract
d. The nature of any recourse provisions that would enable the guarantor to recover from third parties any of the amounts paid under the guarantee
e. The nature of any assets held either as collateral or by third parties that, upon the occurrence of any triggering event or condition under the guarantee, the guarantor can obtain and liquidate to recover all or a portion of the amounts paid under the guarantee
f. If estimable, the approximate extent to which the proceeds from liquidation of assets held either as collateral or by third parties would be expected to cover the maximum potential amount of future payments under the guarantee.

See the Product Warranties Subsection of Section 460-10-50 for an exception to the requirements of (b).

Interpretive response: The disclosures summarized in the following table are required for guarantees in the scope of Topic 460's disclosure requirements and product warranties (unless otherwise noted). The disclosures can be provided for individual guarantees or product warranties, or for groups of similar guarantees or product warranties.

Disclosure	Information to be included in the disclosure
Nature of the guarantee or product warranty [460-10-50-4(a)]	• Approximate term of the guarantee or product warranty. • How the guarantee or product warranty arose. • Events or circumstances that would require the guarantor to perform under the guarantee or product warranty. • The current status of the payment/performance risk of the guarantee or product warranty as of the balance sheet date. — For example, for a credit-risk-related guarantee, the guarantor could disclose recently issued external credit ratings or current internal groupings used by the guarantor to manage its risk. — If internal groupings are used to manage risk, how those groupings are determined and used for that purpose.
Maximum potential amount of future	• Undiscounted maximum amount of future payments that the guarantor could be required to make under

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Disclosure	Information to be included in the disclosure
payments under the guarantee[1] [460-10-50-4(b)]	the guarantee (not reduced by amounts that may possibly be recovered under recourse or collateralization provisions). • If applicable, the fact that there is no limitation on the maximum amount of future payments potentially due. • If applicable, the reasons the guarantor is unable to develop an estimate of the maximum potential amount of future payments under its guarantee.
Liability for the guarantor's obligations under the guarantee or product warranty [460-10-50-4(c)]	• Current carrying amount of any such liability.[2]
Recourse provisions that enable the guarantor to recover from third parties payments made under the guarantee or product warranty [460-10-50-3, 50-4(d)]	• Nature of any such recourse provisions • If estimable, a guarantor considers disclosing the amount of any recovery resulting from its right to proceed against a third party.
Assets held as collateral or by third parties	• Nature of the assets that the guarantor can obtain and liquidate to recover all or a portion of the amounts paid under the guarantee or product warranty. [460-10-50-4(e)] • If estimable, the approximate extent to which the proceeds from liquidation of the assets would be expected to cover the maximum potential amount of future payments under the guarantee or product warranty. [460-10-50-4(f)]

Notes:

1. Product warranties are not subject to this disclosure requirement (see Question 7.7.30).
2. The amount disclosed includes any balance recognized for the contingent component of a guarantee (see section 7.5) and is disclosed regardless of whether the guarantee is freestanding or embedded in another contract.

Question 7.7.30 What incremental disclosures does a guarantor make about product warranties?

Excerpt from ASC 460-10

Product Warranties

50-7 Paragraph 460-10-25-6 states that an inability to make a reasonable estimate of the amount of a **warranty** obligation at the time of sale because of

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significant uncertainty about possible claims precludes accrual. That paragraph also addresses related implications. Paragraphs 450-20-50-3 through 50-6 provide disclosure guidance for circumstances in which no accrual is made for a **loss contingency**. In those circumstances, the disclosures required by that paragraph shall be made.

50-8 A guarantor shall disclose all of the following information for product warranties and other guarantee contracts described in paragraph 460-10-15-9:

a. The information required to be disclosed by paragraph 460-10-50-4 except that a guarantor is not required to disclose the maximum potential amount of future payments specified in paragraph 460-10-50-4(b).
b. The guarantor's accounting policy and methodology used in determining its liability for product warranties.
c. A tabular reconciliation of the changes in the guarantor's aggregate product warranty liability for the reporting period. That reconciliation shall include all of the following amounts:
    1. The beginning balance of the aggregate product warranty liability.
    2. The aggregate reductions in that liability for payments made (in cash or in kind) under the warranty.
    3. The aggregate changes in the liability for accruals related to product warranties issued during the reporting period.
    4. The aggregate changes in the liability for accruals related to preexisting warranties (including adjustments related to changes in estimates).
    5. The ending balance of the aggregate product warranty liability.

Interpretive response: A guarantor is required to provide the disclosures summarized in the following table for all product warranties (see section 7.6), including service-type warranties that are recognized and measured under Topic 606.

Disclosure
When a guarantor does not accrue a warranty obligation because it cannot make a reasonable estimate of the amount, the disclosures for loss contingencies required by Subtopic 450-20 (see section 5.3.30). [460-10-50-7]
The disclosures for guarantees required by paragraph 460-10-50-4 (see Question 7.7.20) except those about the maximum potential amount of future payments under the guarantee. [460-10-50-8(a)]
Guarantor's accounting policy and methodology used in determining its liability for product warranties. [460-10-50-8(b)]
Tabular reconciliation of changes in the guarantor's aggregate product warranty liability for the reporting period, including: [460-10-50-8(c)] • beginning balance; • reductions for payments made (in cash or in kind) under the warranty; • changes for accruals related to product warranties issued; • changes for accruals related to preexisting warranties (including adjustments related to changes in estimates); and • ending balance.

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Example 7.7.10 Product warranty disclosures

The following is an illustrative example of the disclosure requirements in Question 7.7.30.

ABC Corp generally warranties its products against manufacturing and other defects. These product warranties are provided for specific times or usage of the product, or both, depending on the nature of the product, the geographic location of the product's sale and other factors.

As of December 31, Year 2 and Year 1, ABC had accrued liabilities of $2.1 million and $1.85 million, respectively, for product warranty claims. The accrued product warranty costs are based primarily on historical experience of actual warranty claims, as well as current information on repair costs.

The following table provides the changes in ABC's product warranty liability as of December 31.

	December 31	
	Year 2	**Year 1**
Balance at beginning of year	1,850,000	1,600,000
Accrual for warranties issued during the year	800,000	700,000
Warranty claims paid	(630,000)	(525,000)
Changes in liability for preexisting warranties, including expirations	80,000	75,000
Balance at end of year	2,100,000	1,850,000

Question 7.7.40 Does a guarantor disclose information about a guarantee or product warranty if the likelihood of the guarantor making payments under the guarantee or product warranty is remote?

Interpretive response: Yes. Topic 460 disclosures are required regardless of the likelihood of the guarantor making payments – i.e. the disclosures are required even when the likelihood of the guarantor making payments is remote. [460-10-50-2, 50-4, 450-20 Glossary]

Question 7.7.50 What are the additional disclosure requirements for SEC registrants?#

Interpretive response: In addition to Topic 460, SEC registrants with guarantees must consider the disclosure requirements under Regulation S-X and/or Regulation S-K.

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Type	Description
Guarantees of registered securities [S-X Rule 3-01, 3-02, 3-10, 13-01]	Registrants or their subsidiaries may issue debt or debt-like securities that are guaranteed by the registrants or their subsidiaries. A guarantee of a registered security is itself a security; therefore, the security and its guarantor(s) are subject to the reporting and registration requirements of the US securities laws (unless otherwise exempt). The separate reporting requirements of Rules 3-10 and 13-01 are typically satisfied by providing the guarantor's separate financial statements in the issuer's periodic reports or – when certain conditions are met – providing alternative disclosures. See also Questions 8.6.20 and 8.6.110 in KPMG Handbook, Financial statement presentation.
MD&A disclosures (outside the financial statements) [S-K Item 303]	MD&A disclosures required by Reg S-K Item 303 provide information to allow financial statement users to assess the registrant's financial condition and results of operations. This includes information that aids in evaluating the amounts and certainty of cash flows from operations and from outside sources. The disclosures focus on material events and uncertainties known to management that are reasonably likely to result in reported financial information that is not indicative of future financial operating results or financial condition, thereby enhancing a reader's understanding of the registrant's financial condition, cash flows and results of operations. Guarantees subject to the general recognition and measurement provisions of Topic 460 are subject to these MD&A disclosure requirements. In addition, certain parallel requirements apply to foreign private issuers filing on Forms 20-F and 40-F. The required information in MD&A may be similar to, or consistent with, information disclosed in the notes to the financial statements. However, the SEC permits the MD&A disclosures to hyperlink or cross-reference information disclosed in the notes, instead of repeating it, provided that the MD&A disclosures integrate the substance of the notes in a manner that informs readers of the significance of the information. See also Questions 6.2.50 and 7.2.70 of KPMG Handbook, Financial statement presentation.
Affiliates whose securities collateralize securities registered or being registered [S-X Rule 3-16, 13-02]	Financial and nonfinancial disclosures about the collateral pledged and collateral arrangement specified by Rule 13-02 are generally required for registered securities issued on or after January 4, 2021. For registered securities issued and outstanding before January 4, 2021, separate financial statements of the affiliate are required by Rule 3-16 if the affiliates' securities constitute a substantial portion (20% or more of the principal amount of secured class of securities) of the collateral, unless:

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Type	Description
	• the affiliate's financial statements are included elsewhere in the filing; or • the requirements of Regulation S-X Rule 13-02 apply. Financial disclosures may be omitted in certain circumstances. A registrant can provide these disclosures in the consolidated financial statements, MD&A or prospectus.

Question 7.7.60 How do the disclosure requirements of Topic 460 interact with those of other Topics?

Excerpt from ASC 460-10

General

> Effect of the Guarantee Disclosure Requirements on the Disclosure Requirements of Other Topics

50-5 The disclosures required by this Subsection do not eliminate or affect the following disclosure requirements:

a. The requirements in the General Subsection of Section 825-10-50 that certain entities disclose the fair value of their financial guarantees issued
b. The requirements in paragraphs 450-20-50-3 through 50-4 that an entity disclose a contingent loss that has a reasonable possibility of occurring
c. The requirements in the Disclosure Sections of Topic 815, which apply to guarantees that are accounted for as derivatives
d. The requirements in Section 275-10-50 that an entity disclose information about risks and uncertainties that could significantly affect the amounts reported in the financial statements in the near term. See Example 1 (paragraph 460-10-55-25) for an illustration of the required disclosure.
e. The requirements in Section 326-20-50 that an entity disclose information on the measurement of credit loss.

50-6 Some guarantees are issued to benefit entities that are **related parties** such as joint ventures, equity method investees, and certain entities for which the controlling financial interest cannot be assessed by analyzing voting interests. In those cases, the disclosures required by this Topic are incremental to the disclosures required by Topic 850.

Interpretive response: The disclosures required by Topic 460 neither eliminate nor affect disclosure requirements prescribed under other US GAAP. The disclosures in Topic 460 are incremental to these other disclosure requirements. [460-10-50-5 – 50-6]

Other Topics and Subtopics that may require disclosures about guarantees or product warranties include:

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- Topic 275 (risks and uncertainties) (see FASB Example 1, reproduced below, which illustrates how Topic 275's disclosures may apply to a guarantee, and chapter 7 of KPMG Handbook, Financial statement presentation)
- Subtopic 326-20 (see chapter 24 of KPMG Handbook, Credit impairment)
- Subtopic 450-20 (see chapter 5)
- Topic 480 (distinguishing liabilities from equity)
- Topic 606 (revenue from contracts with customers)
- Topic 815 (derivatives and hedging)
- Topic 825 (financial instruments)
- Topic 850 (related party disclosures)
- Topic 855 (subsequent events)

Excerpt from ASC 460-10

General

> Illustrations

• > Example 1: Risks and Uncertainty Disclosure for a Guarantee

55-25 This Example illustrates the disclosure required by paragraph 275-10-50-15(j) of the potential near-term effect of a change in estimate of a contingent liability resulting from the guarantee of the debt of another entity. Entity A's loss of customers causes the potential for a near-term material change in that estimate within the next fiscal year. Although disclosure of Entity A's ongoing efforts to replace those customers is not required, this additional information may be presented.

55-26 Entity A operates a shipping center in Local City. In 19X0, Entity A decided to raise money for modernization of facilities through a debt offering. In order for the offering to take place, Entity B, a local manufacturer, agreed to guarantee the bonds if Entity A's revenues were insufficient to pay debt service. In May 19X4 (four years later when the bonds had an outstanding balance of $55 million), Entity A lost two of its major shipping customers, constituting 35 percent of its prior-year revenues, to a competitor in a neighboring port. At Entity B's June 30, 19X4, year end, Entity A was directing substantial efforts toward finding new customers. It is reasonably possible, however, that Entity A will not replace the lost revenue in time to pay debt service installments at December 30, 19X4, and June 30, 19X5, totaling $6 million.

55-27 Entity B would make the following disclosure.

> In 19X0, Entity B guaranteed the Series AA debt of Entity A, which operates a shipping center within Local City. Entity B continues as guarantor of such debt totaling $55 million. In May 19X4, Entity A lost two of its major customers. Although Entity A is directing substantial efforts toward obtaining new customers, it is at least reasonably possible that Entity A will not replace lost revenues sufficient to make

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its December 19X4 and June 19X5 debt service payments totaling $6 million. If so, Entity B will become responsible for repayment of at least a portion of that amount and possibly additional amounts over the debt term. A liability of $XX has been reported in Entity B's financial statements pending the outcome of Entity A's efforts during the next fiscal year.

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8. Commitments

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Question 8.4.80 Must the amount of the variable component of unrecognized unconditional purchase obligations be disclosed?

Examples

Example 8.4.10 Natural gas pipeline transportation services agreement disclosure

Example 8.4.20 Take-or-pay contract disclosure

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8.1 How the standard works

This chapter addresses disclosures required by Topic 440 for:

- certain commitments; and
- certain unconditional purchase obligations.

Certain commitments

Topic 440 requires the following types of items to be disclosed in the financial statements:

- unused letters of credit;
- leases;
- assets pledged as security for loans;
- pension plans;
- the existence of cumulative preferred stock dividends in arrears; and
- commitments, including:
  - a commitment for plant acquisition;
  - an obligation to reduce debts;
  - an obligation to maintain working capital; and
  - an obligation to restrict dividends.

Topic 440 does not contain specific disclosure requirements for these items – although other Topics may. Instead, it simply states they are to be disclosed in the financial statements.

Unconditional purchase obligations

Although an unconditional purchase obligation is a type of commitment, it is subject to specific disclosures under Topic 440. It is defined as "an obligation to transfer funds in the future for fixed or minimum amounts or quantities of goods or services at fixed or minimum prices."

Unless an unconditional purchase obligation qualifies for a specific scope exclusion, it is subject to Topic 440's disclosures when it has all of the following characteristics.

- It is cancelable only under certain conditions.
- It was negotiated as part of arranging financing for facilities that will provide contracted goods or services or for costs related to those goods or services (e.g. carrying costs for contracted goods).
- It has a remaining term in excess of one year.

Topic 440 contains different disclosure requirements for recognized versus unrecognized unconditional purchase obligations.

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8.2 Overview of Topic 440

Excerpt from ASC 440-10

General

05-1 The Commitments Topic establishes standards of financial accounting and reporting for certain commitments. This Topic contains only the Overall Subtopic. The guidance in this Subtopic is presented in the following two Subsections:

a. General
b. Unconditional Purchase Obligations

05-2 The General Subsections provide guidance for unused letters of credit; preferred stock dividends in arrears; commitments such as those for plant acquisition; and obligations to reduce debts, maintain working capital, or restrict dividends.

05-3 This Topic provides general guidance for commitments, while other Topics include guidance for commitments that relate specifically to those Topics. In addition, commitments that are unique to a particular industry are discussed in the Topic for that industry, generally under the Commitments Subtopic.

> Overall Guidance

15-1 The General Subsection of the Scope Section of the Overall Subtopic establishes the pervasive scope for the Commitments Topic, with specific exceptions noted in the other Subsections of this Section.

> Entities

15-2 The guidance in the Commitments Topic applies to all entities.

Topic 440 applies to all entities. It contains disclosure requirements for:

- certain commitments (see section 8.3); and
- certain unconditional purchase obligations (see section 8.4).

Question 8.2.10 Does Topic 440 include recognition and measurement guidance for commitments and unconditional purchase obligations?

Excerpt from ASC 440-10

Unconditional Purchase Obligations

25-3 The guidance in Section 815-10-15 and paragraph 815-10-55-60 shall be applied to determine whether any portion of the arrangement that is not a lease is subject to Topic 815, and the guidance in Section 815-15-15 shall be

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applied to determine whether any lease portion of the arrangement contains an embedded derivative that is subject to the guidance in Subtopic 815-15.

25-4 Pursuant to paragraphs 330-10-35-17 through 330-10-35-18, accrued net losses on firm purchase commitments for goods for inventory shall be recognized in the accounts.

Interpretive response: No. However, for some types of commitments, Topic 440 identifies other Topics that may provide such guidance. Nevertheless, unless an item is excluded from the scope of Topic 440 (see Question 8.4.40), Topic 440's disclosure requirements apply regardless of whether recognition and measurement requirements of other Topics also apply.

Examples of commitments or obligations for which guidance in other Topics may apply include the following.

Type of commitment or obligation	Addressed in	KPMG Handbook
Net losses on firm purchase commitments for inventory	Topic 330 (inventory)	Inventory
Losses from contracts with customers	Subtopic 605-20 (separately priced extended warranty and product maintenance contracts) Subtopic 605-35 (construction- and production-type contracts) Subtopic 985-605 (certain software arrangements) Paragraphs 954-440-35-1 – 35-3 (continuing care retirement community contracts) Paragraphs 954-450-30-3 – 30-4 (prepaid healthcare services) Paragraph 980-350-35-3 (certain long-term power sales contracts) Paragraph 912-20-45-5 (certain federal government contracts)	Revenue recognition (chapter 13)
Contract termination costs related to exit or disposal activities	Topic 420 (exit or disposal cost obligations)	Employee benefits (chapter 4) Business combinations (chapter 7)
Leases	Topic 842 (leases)	Leases
Derivative instruments	Topic 815 (derivatives and hedging)	Derivatives and hedging

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Type of commitment or obligation	Addressed in	KPMG Handbook
Commitments related to originating, purchasing or selling loans, including mortgage loans	Topic 310 (receivables) Subtopic 326-20 (financial instruments – credit losses) Topic 948 (mortgage banking)	Credit impairment (chapter 13) Derivatives and hedging (section 2.11)
Commitments for post-remediation monitoring	Subtopic 410-30 (asset retirement and environmental obligations)	
Commitments related to pension plans	Topic 715 (compensation – retirement benefits)	Employee benefits
Commitments to make contributions, including promises to give	Subtopic 720-25 (other expenses – contributions made)	
Commitments related to research and development funding arrangements	Subtopic 730-20 (research and development arrangements)	Research and development (chapter 3)
Commitments denominated in a foreign currency	Subtopic 830-20 (foreign currency matters)	Foreign currency
Assets pledged as collateral for secured borrowings	Subtopic 860-30 (secured borrowing and collateral)	Transfers and servicing of financial assets (chapter 8)
Prepaid health care services contracts	Subtopic 954-450 (health care entities)	
Financial instruments (including the fair value option and registration payment arrangements)	Topic 825 (financial instruments)	Investments (chapter 6)

Additionally, an unconditional purchase obligation may represent a variable interest in an entity that results in consolidation of the entity; see chapter 3 of KPMG Handbook, Consolidation.

8.3 Commitments

Excerpt from ASC 440-10

General

50-1 Notwithstanding more explicit disclosures required elsewhere in this Codification, all of the following situations shall be disclosed in financial statements:

a. Unused letters of credit
b. Leases (see Section 842-20-50)

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c. Assets pledged as security for loans
d. Pension plans (see Section 715-20-50)
e. The existence of cumulative preferred stock dividends in arrears
f. Commitments, including:
    1. A commitment for plant acquisition
    2. An obligation to reduce debts
    3. An obligation to maintain working capital
    4. An obligation to restrict dividends.

Topic 440 requires disclosure of certain types of commitments. It does not contain specific disclosure requirements for these items – although other Topics may. Instead, Topic 440 simply states the commitments are to be disclosed in the financial statements.

Question 8.3.10 What types of commitments are disclosed under Topic 440?

Interpretive response: Topic 440 requires the following items to be disclosed: [440-10-50-1]

- unused letters of credit;
- leases (see chapter 12 of KPMG Handbook, Leases);
- assets pledged as security for loans (see Question 7.7.50 about additional disclosure requirements for SEC registrants when affiliates' securities collateralize securities registered or being registered);
- pension plans (see chapter 11 of KPMG Handbook, Employee benefits);
- the existence of cumulative preferred stock dividends in arrears (see Question 5.6.40 and section 5.12.40 in KPMG Handbook, Debt and equity financing); and
- commitments, including:
    - a commitment for plant acquisition;
    - an obligation to reduce debts;
    - an obligation to maintain working capital; and
    - an obligation to restrict dividends.

See section 8.4.20 for disclosures about certain unconditional purchase obligations.

Question 8.3.20 What are the additional presentation and disclosure requirements for SEC registrants?#

Interpretive response: In addition to Topic 440, SEC registrants consider presentation and disclosure requirements under Reg S-X and/or Reg S-K.

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Type	Description
Balance sheet presentation [S-X Rule 5-02.25]	A registrant is required to present a caption, if applicable, on the balance sheet for commitments and contingent liabilities. See Question 3.2.40 in KPMG Handbook, Financial statement presentation.
MD&A disclosures (outside the financial statements) [S-K Item 303(a) and (b)(1)]	MD&A disclosures required by Reg S-K Item 303 provide information to allow financial statement users to assess the registrant's financial condition and results of operations. This includes information that aids in evaluating the amounts and certainty of cash flows from operations and outside sources. The disclosures focus on material events and uncertainties known to management that are reasonably likely to result in reported financial information that is not indicative of future financial operating results or financial conditions, thereby enhancing a reader's understanding of the registrant's financial condition, cash flows and results of operations. A registrant considers material commitments and other cash requirements that are reasonably likely to affect liquidity or capital resources, including the nature of the commitment, expected funding sources, the purpose of the related cash outflows, and material effects of equity and debt financing arrangements and off-balance sheet financing arrangements, when providing these disclosures. In addition, certain parallel requirements apply to foreign private issuers filing on Forms 20-F and 40-F. The required information in MD&A may be similar to, or consistent with, information disclosed in the notes to the financial statements. However, a registrant may disclose different amounts related to purchase obligations in their MD&A compared to their notes to the financial statements because the disclosures required by Topic 440 and Reg S-K Item 303 differ. The SEC permits the MD&A disclosures to hyperlink or cross-reference information disclosed in the notes, instead of repeating it, provided that the MD&A disclosures integrate the substance of the notes in a manner that informs readers of the significance of the information. See also Questions 6.2.50 and 7.2.70 of KPMG Handbook, Financial statement presentation.

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8.4 Unconditional purchase obligations

8.4.10 Scope

Excerpt from ASC 440-10

Unconditional Purchase Obligations

05-4 The Unconditional Purchase Obligations Subsections provide guidance for unconditional purchase obligations, including **take-or-pay** and **throughput contracts**.

Unconditional Purchase Obligations

> Overall Guidance

15-3 The Unconditional Purchase Obligations Subsections apply to all entities and all **unconditional purchase obligations**.

Unconditional Purchase Obligations

25-1 Depending on its terms, an **unconditional purchase obligation** can be subject to the guidance in Topic 842, to the guidance in Topic 815, or to neither.

25-2 The guidance in Section 842-10-15 shall be applied first to determine whether an unconditional purchase obligation is within the scope of Topic 842.

20 Glossary

Take-or-Pay Contract

An agreement between a purchaser and a seller that provides for the purchaser to pay specified amounts periodically in return for products or services. The purchaser must make specified minimum payments even if it does not take delivery of the contracted products or services.

Throughput Contract

An agreement between a shipper (processor) and the owner of a transportation facility (such as an oil or natural gas pipeline or a ship) or a manufacturing facility that provides for the shipper (processor) to pay specified amounts periodically in return for the transportation (processing) of a product. The shipper (processor) is obligated to provide specified minimum quantities to be transported (processed) in each period and is required to make cash payments even if it does not provide the contracted quantities.

Unconditional Purchase Obligation

An obligation to transfer funds in the future for fixed or minimum amounts or quantities of goods or services at fixed or minimum prices (for example, as in take-or-pay contracts or throughput contracts).

Topic 440 requires disclosures about unconditional purchase obligations that have certain characteristics (see Question 8.4.20). However, it provides scope exclusions for certain of those unconditional purchase obligations (see Question 8.4.40).

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Question 8.4.10 What is an unconditional purchase obligation?

Interpretive response: An unconditional purchase obligation is defined as "an obligation to transfer funds in the future for fixed or minimum amounts or quantities of goods or services at fixed or minimum prices." Common unconditional purchase obligations include take-or-pay contracts and throughput contracts. [440-10 Glossary]

Type of contract	Definition
Take-or-pay	An agreement between a purchaser and a seller that provides for the purchaser to pay specified amounts periodically in return for products or services. The purchaser must make specified minimum payments even if it does not take delivery of the contracted products or services. See also Question 8.4.50 and Example 8.4.20.
Throughput	An agreement between a shipper (processor) and the owner of a transportation facility (such as an oil or natural gas pipeline or a ship) or a manufacturing facility that provides for the shipper (processor) to pay specified amounts periodically in return for the transportation (processing) of a product. The shipper (processor) is obligated to provide specified minimum quantities to be transported (processed) in each period and is required to make cash payments even if it does not provide the contracted quantities. See also Example 8.4.10.

Question 8.4.20 Which unconditional purchase obligations are subject to Topic 440's disclosure requirements?

Excerpt from ASC 440-10

Unconditional Purchase Obligations

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.

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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

Interpretive response: Unless an unconditional purchase obligation qualifies for a specific scope exclusion (see Question 8.4.40), it is subject to disclosure when it has all of the following characteristics. [440-10-50-2]

- It is noncancelable, or cancellable only:
  - on the occurrence of a contingent event whose likelihood of occurrence is remote;
  - with the other party's permission;
  - if a replacement agreement is signed between the same parties; or
  - if a penalty is paid and its amount is such that continuation of the agreement appears reasonably assured.
- It was negotiated as part of arranging financing for facilities that will provide contracted goods or services or for costs related to those goods or services (e.g. carrying costs for contracted goods) (see below).
- It has a remaining term in excess of one year.

When evaluating whether the unconditional purchase obligation was negotiated as part of arranging financing, 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. [440-10-50-2]

Question 8.4.30 Is an unconditional purchase obligation associated with a project financing arrangement subject to disclosure?

Background: A project financing arrangement is the financing of a major capital project in which the lender looks primarily to the cash flows and earnings of the project for repayment of the loan and to its assets as collateral. The general credit of the project entity usually is not a significant factor, either because the entity is a corporation without other assets or because the financing is without direct recourse to the entity's owner(s).

Interpretive response: Yes. Unconditional purchase obligations associated with project financing arrangements are disclosed by the purchaser if they have the characteristics in Question 8.4.20 (e.g. remaining term in excess of one year). [FAS 47.BC23(a)]

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Question 8.4.40 What unconditional purchase obligations are excluded from the scope of Topic 440's disclosure requirements?

Excerpt from ASC 440-10

Unconditional Purchase Obligations

> Transactions

15-4 The guidance in the Unconditional Purchase Obligations Subsections does not apply to either of the following:

a. Product financing arrangements, that are within the scope of Section 470-40-15. See paragraph 470-40-05-5 for a discussion of the distinction between a product financing arrangement and an unconditional purchase obligation.
b. Repurchase agreements that are within the scope of Topic 606, specifically in paragraphs 606-10-55-66 through 55-78.

Unconditional Purchase Obligations

50-3 Future **lease payments** under **leases** that meet the conditions in paragraph 440-10-50-2 need not be disclosed in accordance with paragraph 440-10-50-4 or paragraph 440-10-50-6 if those future lease payments are disclosed in accordance with Section 842-20-50.

Interpretive response: The following transactions are not subject to Topic 440's disclosures about unconditional purchase obligations (even if they meet the characteristics in Question 8.4.20).

Type of contract	Additional information
Product financing arrangements in the scope of Subtopic 470-40 [440-10-15-4]	A product financing arrangement is a transaction in which an entity sells and agrees to repurchase inventory with the repurchase price equal to the original sale price plus carrying and financing costs, or other similar transactions. [470-40 Glossary] See section 3.7.40 of KPMG Handbook, Debt and equity financing, for information about product financing arrangements.
Repurchase agreements in the scope of Topic 606 [440-10-15-4]	A repurchase agreement is a contract in which an entity sells an asset and also promises or has the option (either in the same contract or in another contract) to repurchase the asset. The repurchased asset may be the asset that was originally sold to the customer, an asset that is substantially the same as that asset, or another asset of which the asset that was originally sold is a component. [606-10-55-66]

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Type of contract	Additional information
	See section 7.5.50 of KPMG Handbook, Revenue recognition, for information about repurchase agreements.
Future lease payments in the scope of Topic 842 [440-10-50-3]	A lease is a contract, or part of a contract, that conveys the right to control the use of identified property, plant or equipment (an identified asset) for a period of time in exchange for consideration. [842-10 Glossary] Certain unconditional purchase obligations that have the characteristics of paragraph 440-10-50-2 are leases. Those leases are not subject to Topic 440's disclosures about unconditional purchase obligations if they are included in the entity's disclosures under Topic 842. [440-10-50-2] However, if any portion of the lease agreement is not a lease accounted for under Topic 842, it is subject to the disclosures about unconditional purchase obligations. [440-10-50-1 – 50-2] See chapter 12 of KPMG Handbook, Leases.

Question 8.4.50 Is a take-or-pay contract a product financing arrangement that is excluded from the unconditional purchase obligation disclosure requirements?

Interpretive response: No. A take-or-pay contract is not a product financing arrangement because the product in a take-or-pay contract does not yet exist (or it exists in an unsuitable form for the purchaser). In substance, the purchaser in a take-or-pay contract has a right to receive future product but is not the substantive owner of it. Therefore, a take-or-pay contract is not a product financing arrangement in the scope of Subtopic 470-40 and is not excluded from Topic 440's disclosures about unconditional purchase obligations. [440-10-50-4, 470-40-15-3(c)]

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8.4.20 Disclosure

Question 8.4.60 What disclosures are required for unconditional purchase obligations in the scope of Topic 440?

Excerpt from ASC 440-10

Unconditional Purchase Obligations

> 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.

> 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.

50-7 Paragraph 815-10-50-6 explains that, if an unconditional purchase obligation is subject to the requirements of both this Subtopic and Subtopic 815-10, the entity shall comply with the disclosure requirements of each Subtopic including paragraph 440-10-50-4.

Interpretive response: It depends on whether the in-scope unconditional purchase obligation is recognized on the purchaser's balance sheet – i.e. whether it is a recognized or unrecognized commitment.

Recognized vs unrecognized	Required disclosures
Recognized	Aggregate amount of payments for each of the five years following the latest balance sheet date. [440-10-50-6]
Unrecognized	The following information, unless the aggregate commitment for all in-scope unconditional purchase obligations not disclosed is immaterial: [440-10-50-4]

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Recognized vs unrecognized	Required disclosures
	• nature and term; • aggregate amount of the fixed and determinable portion as of the latest balance sheet date presented and, if determinable, for each of the five succeeding fiscal years; • nature of any variable components; and • amounts purchased under the obligation (e.g. the take-or-pay or throughput contract) for each income statement period presented.

If an entity has in-scope unrecognized unconditional purchase obligations that are similar or related, the disclosures may be combined. [440-10-50-4]

Question 8.4.70 Must the amount of imputed interest necessary to reduce unrecognized unconditional purchase obligations to their present value be disclosed?

Excerpt from ASC 440-10

Unconditional Purchase Obligations

> Unrecognized Commitments

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.

Interpretive response: No. When preparing its disclosures about the fixed and determinable portion of its in-scope unrecognized unconditional purchase obligations, an entity is encouraged – but not required – to disclose the amount of imputed interest necessary to reduce the obligation to its present value. If an entity discloses that information, the discount rate used is the effective initial interest rate of the borrowings that financed the facility that will provide the contracted goods or services. However, if the purchaser does not know that rate, the discount rate reflects its incremental borrowing rate at the date the obligation is entered into. [440-10-50-5]

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Question 8.4.80 Must the amount of the variable component of unrecognized unconditional purchase obligations be disclosed?

Interpretive response: No. An entity must disclose the nature of the variable component, but does not need to quantify the future obligation (e.g. as of its balance sheet date) in its disclosures. However, the variable component is included when disclosing the amounts purchased for each income statement period presented. [FAS 47.BC21]

8.4.30 Examples

Excerpt from ASC 440-10

Unconditional Purchase Obligations

> Illustrations

55-1 This Section, which is an integral part of the requirements of this Subtopic, provides general guidance to be used in the disclosure of **unconditional purchase obligations**.

• > Example 1: Throughput Agreement with Advance Payments for Future Throughput

55-2 This example illustrates the guidance in paragraphs 440-10-50-4 through 50-5.

55-3 Entity A has entered into a **throughput contract** with a manufacturing plant providing that Entity A will submit specified quantities of a chemical (representing a portion of plant capacity) for processing through the plant each period while the debt used to finance the plant remains outstanding. Entity A's processing charges are intended to be sufficient to cover a proportional share of fixed and variable operating expenses and debt service of the plant. If, however, the processing charges do not cover such operating expenses and debt service, Entity A must advance additional funds to cover a specified percentage of operating expenses and debt service. Such additional funds are considered advance payments for future throughput.

55-4 Entity A's unconditional obligation to pay a specified percentage of the plant's fixed operating expenses and debt service is fixed and determinable, while the amount of variable operating expenses that Entity A is obligated to pay will vary depending on plant operations and economic conditions.

55-5 Entity A's disclosure might be as follows.

> To secure access to facilities to process chemical X, the entity has signed a processing agreement with a chemical supplier allowing the entity to submit 100,000 tons for processing annually for 20 years. Under the terms of the agreement, the entity may be required to advance funds against future processing charges if the chemical supplier is unable to meet its

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financial obligations. The aggregate amount of required payments at December 31, 19X1, is as follows (in thousands).

19X2	$10,000
19X3	10,000
19X4	9,000
19X5	8,000
19X6	8,000
Later years	100,000
Total	145,000
Less: Amount representing interest	(45,000)
Total at present value	$100,000

In addition, the entity is required to pay a proportional share of the variable operating expenses of the plant. The entity's total processing charges under the agreement in each of the past 3 years have been $12 million.

Example 8.4.10 Natural gas pipeline transportation services agreement disclosure

This example is based on an example in paragraphs 27 and 28 of FASB Statement No. 47, Disclosure of Long-Term Obligations *(FAS 47), which was not codified.*

On January 1, Year 1, Customer (a natural gas producer, sometimes referred to as a 'shipper') enters into a 15-year firm transportation services agreement with Transporter (pipeline company) stating that Customer will ship up to a specified volume of Customer's natural gas from one specified location to another specified location for the duration of the agreement through Transporter's newly constructed pipeline. Transporter must reserve a portion of its pipeline capacity for Customer commensurate with contracted transportation volumes, and cannot market the reserved capacity to other potential customers for the duration of the agreement. The duration of the agreement is the same as the duration of the debt used to finance the pipeline. The transportation agreement does not contain a lease of the pipeline.

Fees for transportation services under the agreement are the pipeline tariff rates approved by the Federal Energy Regulatory Commission. The tariff contains the following two charges.

Charge	Customer's obligation
Demand charge[1]	A reservation fee based on the contracted capacity, regardless of actual volumes shipped. The demand charge multiplied by the contracted capacity represents a fixed and determinable payment.
Commodity charge[2]	A transportation fee based on actual volumes shipped. The commodity charge represents a variable component.

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Notes:
1. Computed to cover debt service, depreciation and certain expected expenses.
2. Covers other expenses and provides a return on Transporter's investment.

The firm transportation services agreement represents a throughput contract that is an unconditional purchase obligation and meets the requirements for disclosure under Topic 440 as an unrecognized commitment (see Question 8.4.20). Customer elects to disclose the amount of imputed interest necessary to reduce the unconditional purchase obligation to its present value (see Question 8.4.70).

Disclosure

Customer discloses the following about this arrangement in its Year 2 financial statements.

> On January 1, Year 1, Customer entered into a firm natural gas transportation services agreement securing natural gas transportation capacity up to an agreed maximum volume through Year 15. Under that agreement, Customer must make periodic fixed demand charge payments to reserve a portion of pipeline transportation capacity as well as variable commodity charge payments for the actual volumes shipped during the period. The aggregate amount of the fixed demand charge payments at December 31, Year 2 is as follows (in thousands).
>
> | | |
> |---|---|
> | Year 3 | 5,000 |
> | Year 4 | 5,000 |
> | Year 5 | 5,000 |
> | Year 6 | 4,000 |
> | Year 7 | 4,000 |
> | Later years | 26,000 |
> | Total | 49,000 |
> | Less amount representing interest | (9,000) |
> | Total at present value | 40,000 |
>
> Customer must also pay additional variable commodity charge amounts depending on actual volumes shipped under the agreement.
>
> Customer's total payments under the agreement (in thousands) were $6,000 in Year 1 and $5,500 in Year 2.

Example 8.4.20 Take-or-pay contract disclosure

This example is based on an example in paragraphs 29 to 30 of FAS 47, which was not codified.

On January 1, Year 1, Buyer enters into a 27-year take-or-pay contract with Seller (an ammonia plant). Buyer is obligated to purchase 50% of the planned

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production capacity of the plant each period while specified debt used to finance the plant remains outstanding.

The monthly payment equals the sum of 50% of each of the following.

Buyer's obligation	Type of obligation
Raw material costs	Variable
Operating expenses	Variable
Depreciation	Fixed and determinable
Interest at a fixed rate on the specified debt	Fixed and determinable
Return on Seller's equity investment	Fixed and determinable

The agreement represents a take-or-pay contract that is an unconditional purchase obligation and meets the requirements for disclosure under Topic 440 as an unrecognized commitment (see Question 8.4.20). Buyer elects to disclose the amount of imputed interest necessary to reduce the unconditional purchase obligation to its present value (see Question 8.4.70).

Disclosure

Buyer discloses the following about this arrangement in its Year 2 financial statements.

> To ensure a long-term supply, on January 1, Year 1, Buyer signed an agreement to purchase half the output of an ammonia plant for 27 years. Under that agreement, Buyer must make minimum annual payments, whether or not it is able to take delivery. The aggregate amount of the required payments at December 31, Year 2 is as follows (in thousands).
>
> | | |
> |---|---|
> | Year 3 through Year 7 ($6,000 per annum) | 30,000 |
> | Later years | 120,000 |
> | Total | 150,000 |
> | Less amount representing interest | (65,000) |
> | Total at present value | 85,000 |
>
> Buyer must also reimburse Seller for a proportional share of raw material costs and operating expenses of the plant.
>
> Buyer's total payments under the agreement were (in thousands) $7,000 and $7,100, in Year 1 and Year 2, respectively.

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Index of changes

This index lists the significant additions and changes made in this edition to assist you in locating recently added or updated content. The following symbol is used throughout this Handbook to indicate the type of revisions made in this edition for sections, Questions, Examples and other items:

\# significant updates or revisions to the item

6. Gain contingencies and loss recoveries

Question

Question 6.3.30 Can government grants be accounted for under the gain contingency model?#

7. Guarantees and product warranties

Questions

Question 7.6.50 When is a product warranty considered assurance-type vs service-type?#

Question 7.7.50 What are the additional disclosure requirements for SEC registrants?#

8. Commitments

Question

Question 8.3.20 What are the additional presentation and disclosure requirements for SEC registrants?#

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- Climate risk in the financial statements
- Consolidation
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- Credit impairment
- Crypto assets
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- Discontinued operations and held-for-sale disposal groups
- Earnings per share
- Employee benefits
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- SEC pro forma financial information
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- Service concession arrangements
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- Software and website costs
- Statement of cash flows
- Tax credits
- Transfers and servicing of financial assets

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