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Contingency liabilities: The effect of three alternative reporting styles

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A B S T R A C T

The International Accounting Standards Board's (IASB) new international financial reporting standards (IFRS) relating to contingencies became effective on January 1, 2011, officially replacing the CICA's (Canadian Institute of Chartered Accountants) contingent liability accounting standards for publicly accountable enterprises. Although both sets of standards (IFRS and CICA) are based on fundamentally similar conceptual frameworks, they differ significantly in certain respects. This study examines the changes now required in contingency reporting and their implications for regulators. Rules for contingency reporting were previously dictated by Canadian GAAP (CGAAP), as formulated by the Canadian Institute of Chartered Accountants, but are now subject to the IASB's IAS 37. However, to enhance clarity and ease of understanding for financial statement users, the IASB has proposed a new version of contingent liability accounting standards under IFRS, titled exposure draft IAS 37. The message conveyed by the three different types of reporting is investigated, with findings that have implications for other similar rules adopted by IASB. Results indicate variations in four types of judgments by the Canadian loan officers in the experiment. Although their loan granting decisions were not influenced by the change to IASB's IAS 37, the officers charged significantly different interest premiums according to the type of financial statement received, i.e. based on former Canadian requirements, the original IAS 37 or the proposed IAS 37 exposure draft. Loan officers' judgments are therefore influenced by the way contingent liabilities are presented, a finding that has implications for regulators, mainly in view of the fact that the proposed IAS 37 reporting style could facilitate clarity and understanding of these liabilities.

1 Objective

This study examines whether the signals conveyed by the application of different formatting requirements, especially for contingent liabilities, affect the judgments and decisions of loan officers. A comparison is made of reactions to the requirements of the post International Financial Reporting Standard (IFRS) regime and its predecessor, Canadian Generally Accepted Accounting Principles (CGAAP). If judgments are found to be affected, the results could be extrapolated to similar situations in which regulators consider alternative forms of disclosure. Regarding contingent liabilities, the former Canadian Institute of Chartered Accountants (CICA) requirements (CICA section 3290) did not stipulate separate recording in the balance sheet or disclosure of the probability of occurrence. The potential liability could therefore be camouflaged by including it with other liabilities. Under IFRS, both IAS 37 and the newly updated IAS 37 exposure draft require that the event's probability (in this particular study, a lawsuit) be disclosed in the note and the amount of the potential contingent liability provided separately in the balance sheet. The fundamental

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difference between the IFRS standards stems from the technique for recognizing the loss. The current IAS 37 requires that the amount recorded be based on a *reliable* estimate of the figure most likely to be paid for settling the obligation at the closing date, whereas the proposed IAS 37 exposure draft stipulates that the liability should be recorded at the amount that would rationally be paid at the end of the reporting period. As a result of the new method, compared to the value reported under the original IAS 37 requirements (as well as CICA section 3290), the revised IAS 37 entails a change in the contingent liability and its attendant loss value (and, under some circumstances, results in an even lower value). Reported earnings could thus be higher under the revised exposure draft.

The objective of this study is to explain how differences in contingent liability reporting influence the judgments of sophisticated users. This knowledge and the information it provides on the effect of various reporting formats have implications for regulators, especially IFRS administrators. Although contingent liabilities are the focus of the current investigation, the results can most likely be extrapolated to other areas of financial accounting for which regulators are considering alternative forms of reporting.

This study uses an experimental design in which all variables are held constant and are subject to manipulation of the reporting and disclosure formats for contingent liabilities. The results obtained are mixed overall but nonetheless show significant variations in four types of judgments, especially the interest rate premium charged by the three loan officer groups (for which financial statements were provided based on 1) the IAS 37 exposure draft; 2) current IAS 37; or 3) Canadian accounting standards). Specifically, the groups' judgments and decisions are significantly different under the IAS 37 exposure draft, an observation discussed in section 3. In the next section some background on the International Accounting Standards Board (IASB) is provided to explain the current research objectives and rationale.

2 Background and rationale

The International Accounting Standards Board (IASB) works to develop "a single set of high quality and comparable reporting standards that will offer an improved basis for decision making for business and investors" (Canadian Institute of Chartered Accountants, 2009, p. 1). It has also been suggested that the IASB provides "the best information possible to support strategic and tactical decision making" (Canadian Institute of Chartered Accountants, 2009, p. 1), with the result that it fosters better allocation of capital. In addition, having common standards across nations is expected to contribute to a global profession for accountants and reduce the burden on regulators.

The IASB attempts to establish a balance between rule-based and principle-based standards. However, the road map to convergence does not provide that different nations should have the exact same standard, but rather that some differences are possible despite the standards being structured more or less around the same principles. IFRS and CICA standards are both based on fundamentally similar conceptual frameworks (with similar style and form), but differ significantly in some ways.

One major difference is in the area of contingencies, since January 1, 2011, when IFRS officially replaced the CICA handbook's accounting standards for publicly accountable enterprises. As shown in Table 1, under Section 3290 of the CICA Handbook, a contingent liability must be recorded if (1) the event causing the loss is likely to occur (high probability of occurrence), and (2) the amount of the contingent loss can be appraised with a degree of certainty. The amount to be recorded should be based on a *reasonable* estimate of the most likely amount to be paid. This recorded liability is presented with other liabilities (i.e., not separately) in the balance sheet. In contrast, under current IAS 37, contingent losses are recorded as liabilities when (1) there is a current obligation, and (2) the outflow of resources embodying economic benefits is probable (i.e. more probable than improbable); this occurs when the likelihood of such losses exceeds 50%, which is a probability threshold lower than that recommended by CICA's section 3290), and (3) there is a *reliable* estimate. The amount most likely to bring about the elimination of the obligation at the closing date must be recorded (Chlala, Lavigne, & Vendette, 2009). The amount under IAS 37 is, in most instances, similar to the amount recorded under the previous CICA's section, but the liability under IAS 37 is presented as a separate item in the balance sheet, a departure from Canadian GAAP (CGAAP). These requirements are in a state of flux, however, as the IASB has issued proposals in an exposure draft (Canadian Institute of Chartered Accountants, 2009) that eliminate a provision's recognition criterion with reference to the probability of occurrence, and include the likelihood of disbursement in the measurement of the liability. Thus, as indicated in Table 1, the measurement would be the amount that the entity would rationally pay at the measurement date to relieve itself of the liability (i.e. the amount equivalent to the expected value). This recorded liability is presented in the same way as under IAS 37, i.e. as a separate liability even if the recorded amount under IAS 37 is likely to be different.[1] In the current investigation, tests were run to check whether loan officers differ in their judgments or decisions as a result of the influence of specific changes required by IFRS (both current and proposed IAS 37) compared to the types of decisions made when information is presented according to CICA accounting standards, especially as regards contingent liabilities.

The research question at issue is whether financial statements based on IFRS (specifically, contingent liabilities using the current and proposed IAS 37) are easier to read and convey a better understanding than those based on requirements of Canadian accounting standards. The study was conducted as an experiment using Canadian loan officers assigned randomly into three groups according to the type of financial statements they received and the method used

[1] Even if net income is different under the IAS 37 exposure draft versus the current IAS37, the information provided in the note according to the IAS 37 exposure draft would allow reconciliation of net income disclosed according to IAS 37. Thus, the information is available but located in a different place.