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## Financial Information about Risks: Contingent and Incidental Liabilities

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*Keywords* : *International Accounting Standard 37, disclosure, risks.*

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*Strictly as per the compliance and regulations of:*



# Financial Information about Risks: Contingent and Incidental Liabilities

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**Abstract:** This research propose the convenience of take into account the incidental liabilities in financial reporting about risks, in order to generate better financial information as a result of lack of criteria not only at international financial reporting standards, also in the United States, United Kingdom, Spain and Mexico. This research identifies and describes several risk ratings, considering the points of view of academics and in addition, considering the best practices of several well known multinational companies, focusing on the hospitality industry. Subsequently, the research concludes with a proposal in order to disclose incidental liabilities inspired by the format as international financial reporting standards provide, becoming this an unpublished material that contributes to standardization in the disclosure of risks across financial reporting standards.

**Keywords:** *International Accounting Standard 37, disclosure, risks.*

## I. INTRODUCTION

The lack of quality in the financial information concerning to disclosure of risks, especially the incidental risks or whose possibility of occurrence is considered too low, is due to creative accounting caused by ignorance or bad faith of those who develop financial information, as it happened in the cases of Enron and WorldCom whose risks were not disclosed widely for the benefit of a few. This research exposes the need for better disclosure of risks to inform the users about the real financial situation of the economic entity.

## II. HYPOTHESIS

There is an opportunity area in the disclosure of financial information related to risks, by applying the concept of incidental liabilities with remote possibility of occurrence.

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## III. GENERAL OBJECTIVE

The general objective of this research is to demonstrate the deficiency in information in the financial statements about of disclosure of low probability risks or remote, proposing the development of the concept incidental liabilities with remote possibility of occurrence, based in the analysis of international financial reporting standards.

## IV. THEORETICAL FRAMEWORK

The decrease in wealth can be caused by several factors highlighting the meteorological, technological and political causes (Eeckhoudt, 2004). In this way, the uncertainty is an unavoidable element for any kind of risk (Callao and Jarne, 1995; Rodríguez, 1993). In the business world, the uncertainty is linked to the inhibition of the investment and is an impediment when generating new jobs (Lainez, 1993). Landry (2002) highlights four levels of uncertainty: the clear future, alternative scenarios, potential future and total confusion scenario. So, when the uncertainty increases, increases the chance of a casualty loss that despite being considered as low probability event is latent to happen. The natural hazards should not be excluded in the analysis of the companies when developing its sustainability reports, stressing in this way The Global Reporting Initiative (GRI, 2002). This Initiative promotes good practices in sustainable development information (Larrinaga and Moneva, 2002; Carmona, 2003), in a scenario where the climate change is considered a real unavoidable risk in the near future (O'Meara, 2005).

The multinational hotel industry classifies its risks in terms of material losses, civil liability, loss of profit, financial risks, political risks, operational and market risks (Best Western, 2007; Inter Continental Hotels Group, 2007; Sol Meliá, 2007, Starwood Hotels & Resorts Worldwide, 2007). The manufacturing industry classifies its risks in terms of currency exchange rates, interest rate, commodity price, increased costs and market value risks (Ford Motor Company, 2007, General Electric Company, 2007; General Motors Corporation, 2007, The Coca Cola Company, 2007). The international financial industry classifies its risks in terms of credit,

market, operational and insurance risks (Banco Bilbao Vizcaya, 2007, Banco Santander Central Hispano, 2007, Citigroup, 2007, HSBC, 2007). The business risks are events that prevent the company to achieve its objectives. These can be classified in terms of financial risks, operational, natural disaster risk and, law violation risks (Fuente, 2006; Mills, 2003). In this risk scenario, the *Conceptual Framework* of the International Accounting Standards Board (2008) better known as IASB, has focused on meeting the needs of users, promoting the generation of useful data for decision making. So, it sets out the concepts that underlie the preparation and presentation of financial statements for external users.

The IASB notes that "the accrual basis of accounting" is the fundamental hypothesis in order to meet the objectives of the financial statements. Additionally, the IASB states that financial statements should also contain notes, supplementary schedules and other information that explains the items in the balance sheet and income statement, revealing risks and uncertainties that may affect the entity. The international financial reporting standards recognize provisions as liabilities with uncertain in amount and maturity, they are present obligations for the entity and they have a reliable estimate (Nobes, 1998; Choi and Mueller, 2002). A contingent liability is a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity. Also it can be a present obligation that arises from past events but is not recognized because it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation or, the amount of the obligation cannot be measured with sufficient reliability. (*International Accounting Standards Board, 2008; Normativa de Contabilidad y Auditoría Española, 2005; Financial Accounting Standards Board, 2008; Instituto Mexicano de Contadores Públicos, 2008; Instituto de Contabilidad y Auditoría de Cuentas, 2005*).

The international financial reporting standards recommend that due to the uncertainty in a present obligation, an accounting provision should be recognized. Later, if it is forecasted that such provision has a low probability of materializing, it should be recognized only in notes to the financial statements as a contingent liability and, if it is considered as remote the possibility of occurrence of this contingent liability, then it is no necessary to disclose this liability. In this context, the concept of *incidental liabilities with remote possibility of occurrence* that is proposed to discuss in this research, is a possible obligation that not necessarily arises from a past event and it is not expected to be confirmed, it only promotes to disclosure the possible negative impacts for the entity in a remote scenario. About the disclosure of risks according to

several international financial reporting standards, the OFR report or better known as Operating and Financial Review from the United Kingdom (Department for Business Innovation and Skills; 2008) recommends the identification of at least three risks: non-financial, environmental and, ethical or reputational, coinciding with the international financial reporting standards with regard to the disclosure of liabilities and contingencies. The risk caused by an incidental contingency is not necessary to be disclosed unless the possibility may be considered reasonable and not remote. By comparing the International Financial Reporting Standards and regulation according to the Financial Accounting Standards Board in terms of disclosure of risks and contingencies, both regulations concur in stating that the provisions should be recognized, while contingencies should be revealed, and only in the case of events with low probability of occurrence its disclosure is discretionary (*International Accounting Standards Board, 2008; Financial Accounting Standards Board, 2008*). Regulatory authorities in financial reporting standards have made efforts to achieve greater relevance in the financial statements, (Lainez and Callao, 2000; Lainez and Fuertes, 2004), highlighting the following information:

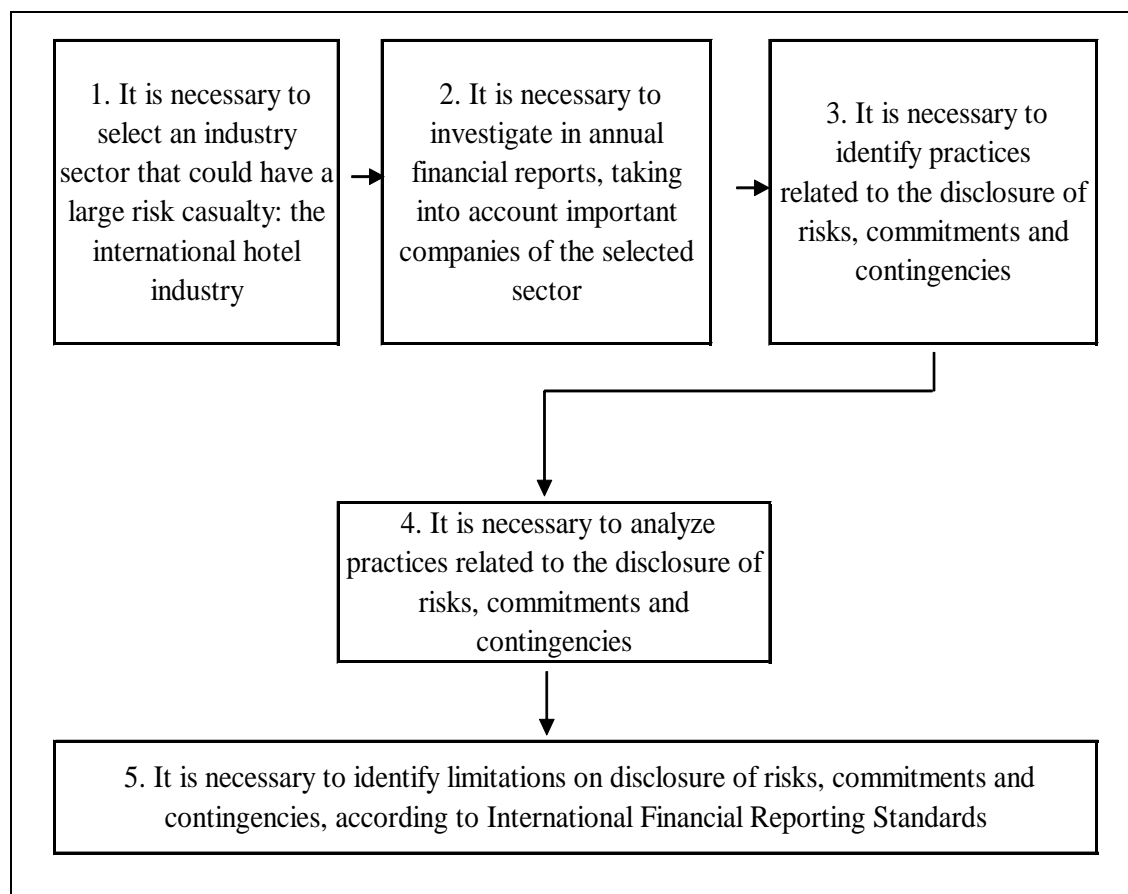
- The American Institute of Certified Public Accountants / AICPA since 1991 appointed a Special Committee on Financial Reporting to increase the usefulness of financial information, including plans, opportunities, risks and uncertainties measurement.
- In 1993 the Association for Investment Management and Research / AIMR, coincided with the AICPA on providing users with information related to the strategic financial position of the company, including disclosure of risks.
- In 1998, the Financial Accounting Standards Board / FASB established a committee in order to study the information disclosure practices, resulting in the document called Insights into Improving Business Reporting Enhancing Voluntary Disclosures.

Therefore, there are several international regulators agencies concerned with the financial information reporting that agree in consider that the disclosure in the financial statements can be improved.

## V. MODEL OF STUDY

The following illustrates the process established to conduct this research and achieve the proposed goal (Table I).

*Table 1:* Process to identify constraints in the financial information related to disclosure of risks and contingencies



Source: Own elaboration.

## VI. METHODOLOGY

For this analysis, the investigation has been designed with the following characteristics (Table II).

*Table 2.* Research design

Variables used	Not experimental research	The research investigated the disclosure of risks, commitments and contingent liabilities
Information sources	Documentary research	The research collected financial statements, annual reports and management reports of prestigious multinational companies, available on their Web sites into sections identified as "Investor Relations"
Extension of the study	Cross-sectional research	The documental research focused on information corresponding to the year 2007
Analysis of information	Descriptive research	The research identified practices related to disclosure of risks, commitments and contingencies, to get conclusions about it

Source: Own elaboration.

The process to identify constraints in the financial information relating to disclosure of risks and contingencies is summarized next:

- Selection of companies to analyze. Within the multinational hotel industry the companies selected were Sol Meliá, Best Western, Starwood Hotels & Resorts Worldwide, and Inter Continental Hotels Group, according to the following criteria: it should be one of the most known worldwide chain hotels, with facilities over the five continents and it must have obtained a return on assets of 5% at least.
- Investigation in annual financial reports. The research process reviewed the annual and management financial reports to determine the main reasons for disclosing contingent liabilities and commitments in the notes to financial statements.
- Identification of practices related to disclosure of risks, commitments and contingencies. The 100% of the companies that were analyzed have disclosed their risks on management reports and 25% did it extensively in their annual reports, but out of notes to the financial statements.
- Analysis of practices related to the disclosure of risks, commitments and contingencies. The results are summarized next (Table III):

*Table 3:* Analysis of practices related to the disclosure of risks, commitments and contingencies

Company	Sol Meliá	Best Western	Inter Continental	Starwood
<b>Risks disclosed in management reports</b>				
Liquidity risk	x	x	x	✓
Risk of litigation, claims	x	x	x	✓
Interest rate risk	x	x	x	✓
Natural disasters	✓	✓	x	✓
Business interruption	✓	x	x	✓
Terrorism	✓	x	✓	✓
War	✓	x	✓	✓
Risk of uncollectible accounts	✓	✓	✓	x
Customer fears	x	x	✓	✓
Government regulations	✓	x	x	✓
<b>Risks disclosed in annual reports, but outside of the notes to financial statements</b>				
Material losses	✓	x	x	x
Responsibilities to others	✓	x	x	x
Loss of profit	✓	x	x	x
Financial risk	✓	x	x	x
Political risk	✓	x	x	✓
Operational risk	✓	x	x	x
Credit risk	x	x	x	x
Insurance risk	x	x	x	x
Acts of God	x	x	x	✓
<b>Risks, contingencies and subsequent events that were disclosed in the notes to financial statements</b>				
<b>Contingencies</b>				
Litigation	x	✓	x	✓
Bonds issued under warranty	✓	x	✓	✓
Implied obligations	✓	x	✓	✓
<b>Subsequent events</b>				
Disclosure of last year strategies in order to envision future benefits	✓	✓	✓	✓
<b>Other comments about risks</b>				
The company mentioned that has valued its risks	x	x	x	x
The company accepted that 100% of the potential risks are not covered by insurance	x	x	x	✓

*Source:* Own elaboration based on annual financial reports corresponding to the year 2007

- Identification of the limitations on disclosure of risks, commitments and contingencies, according to the International Financial Reporting Standards. It has been distinguished the lack of harmonization or uniformity in the manner that the analyzed companies disclosed their risks.

## VII. RESULTS AND CONCLUSIONS

The results of this research conclude that:

- It is allowed by the international financial reporting standards to disclose information about risks and contingencies. However, it is not done in detail by the constraints of scope stated in the standards. So, the companies analyzed have disclosed their risks in annual reports done by the management but outside their financial statements, so they did not disclose their low probability risks.
- This deficiency in the disclosure of risks is based mainly on the opinion of management and therefore, there is no any standardization and homogeneity in this kind of disclosures.
- The notes related to the events after the balance sheet date, usually include good news about favorable results expected to be obtained by actions taken in the last year, excluding information on specific risks.
- Then, it is feasible the application of the *incidental liabilities with remote possibility of occurrence* based on business risks, due to that the risks with low probability of occurrence are usually excluded, despite that some risks have been disclosed in annual reports but outside the financial statements.

## VIII. THEORETICAL PROPOSAL

Given the lack of uniformity in the disclosure of risks in the financial statements, taking into account the guidelines and limitations in the International Accounting Standard 37 and other rules that promote to disclosure certain kind of risks, it is proposed to discuss the feasibility of issuing a similar guide to the next in international financial reporting standards:

### 1) Objective

The objective of this proposal is to encourage the entity to disclose in notes to the financial statements sufficient information related to risks that have the possibility to generate liabilities as a result of fortuitous events.

### 2) Scope

1 This standard shall be applied to inform on incidental liabilities with remote possibility of occurrence, that were not disclosed according to another specific standard and they were not considered as a contingent liabilities.

2 Examples of standards to which the preceding paragraph refers that in the present or in the subsequent years require disclosures related potential liabilities as a consequence of events with remote possibility of occurrence are:

### Disclosure of incidental liabilities with remote possibility of occurrence

Index	Paragraph
Objective	
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- Consequently, the dilemma in the financial reporting standards between what is incidental and what it is not, allows distinguishing the boundary between a liability with low probability of occurrence and a contingent liability.
  - a) Events after the balance sheet date (see IAS 10 *events after the Balance Sheet Date*);
  - b) Construction contracts (see IAS 11 *construction contracts*);
  - c) Income taxes (see IAS 12 *income taxes*);
  - d) Leases (see IAS 17 *leases*);
  - e) Employee benefits (see IAS 19 *employee benefits*);
  - f) Provisions and contingent liabilities (see IAS 37 *provisions, contingent liabilities and contingent assets*);
  - g) Financial instruments (see IAS 39 *financial instruments: recognition and measurement*);
  - h) Business combinations (see IFRS 3 *business combination*);
  - i) Insurance contracts (see IFRS 4 *insurance contracts*).

**3** If the entity estimates some kind of income or assets as a result of fortuitous events, this will never be disclosed according to reasonable criteria established in the conceptual framework of international financial reporting standards.

### 3) Definitions

**4** The following terms are used in this standard with the meaning specified:

**5** A *risk* is an event that have not happened yet with latent possibility of occurring, which may be real in the future credibly and may cause adverse effects in the performance of the entity, being the cause of disclosing incidental liabilities with remote possibility of occurrence.

**6** *Incidental liabilities with remote possibility of occurrence* arise as a result of remote events that have not happened yet and they are not present obligations. However, these remote events could generate real obligations as a result of loss of assets due to the completion of the mentioned remote event.

**7** A *present obligation* is an obligation that is real, exists, is quantified, is recognized and disclosed at the date of the financial statements.

**8** The term *real* means the beginning and the consequent existence of something.

### 4) Incidental Liabilities With Remote Possibility Of Occurrence

**9** The incidental liabilities with remote possibility of occurrence as previously defined, can be caused among others by some of the following risks:

- a) Operational risk: a result of decrease in the liquidity of the company, adverse results in litigation and guarantees to third parties, increased costs, negative effects on employment matters, asset repurchase obligations, the breach of contracts, compensation to customers by defective goods and services, and considering the uncertainty on corporate tax legislation or its equivalents.
- b) International transactions risk: as a result of changes in tariffs, border crossings and international economic crisis.
- c) Financial risk: as a result of uncertainty in currency exchange rates, interest rates and matters with regard to obtaining finance and credit.
- d) Natural risk: as a result of natural disasters and events that could result in the termination of the activity of the entity, either temporarily or permanently.
- e) War risk: as a result of war and terrorist activity.
- f) Market risk: as a result of loss of market value, uncollectible accounts, fears of customers, competitors on the Internet, lack of ethics and reputational matters.

g) Political risk: as a result of government regulations in their respective countries, monetary and environmental restrictions, expropriation, political instability and the international political conditions.

**10** The risks mentioned, among others, could lead to incidental liabilities with remote possibility of occurrence and they could cause future outflow of resources.

**11** The incidental liabilities with remote possibility of occurrence could arise if the remote risk related becomes real. However, there is no certainty if the current or the next management board will suffer its consequences in the future.

**12** The incidental liabilities with remote possibility of occurrence are not present obligations and should not be recognized however, its disclosing would allow users to further analyze the assets of the entity from the perspective of uncertainty.

**13** In case of happening the risks above mentioned could result in real obligations for the entity, generating the potential to decrease the fair value of certain assets which regardless of its corresponding impairment loss, will be necessary to compensate them and maybe incur in liabilities.

**14** In order to disclose its impact and as a result of incidental loss of assets due to latent risks that face the entity, the liabilities resulting from events whose possibility is remote must not exceed the fair value of those assets at the balance sheet date.

**15** When the incidental liabilities with remote possibility of occurrence becomes an actual fact, may be regarded first as a contingent liability and later as a provision, in line with the International Accounting Standard 37. In addition, the corresponding impairment of assets must be taken into account according to the International Accounting Standard 36.

### 5) Best Estimate

**16** the value disclosed as incidental liabilities with remote possibility of occurrence should be the disbursement that would be required to compensate the assets affected by the possible misfortune.

**17** The amount to which the preceding paragraph refers will be as maximum the value of the related assets at the balance sheet date, according to the international financial reporting standards required for each class of assets.

**18** The best estimate of "the incidental liabilities with remote possibility of occurrence" will rely on the discretion of the administration of the entity taking into account the constraint mentioned in the last paragraph, understanding that if the value of this obligation is material in comparison with the value of total assets at the balance sheet date, the business continuity of the entity would be seriously influenced by the risks involved in this disclosure.

19 The resulting value of this procedure must be reviewed annually, considering the need to foresee new risks, even could be necessary to remove some of the existing risks if the management of the entity considers that they already are not.

6) *Disclosure*

20 The incidental liabilities with remote possibility of occurrence shall be disclosed in notes to financial statements. The estimated value is determined taking into account the risks and its imminent impact on assets. This amount shall be displayed as decreasing the total assets. So, the resulting difference represents the asset guaranteed synonymous of risk-free assets.

21 In addition, the entity shall disclose:

- Comparative information about the incidental liabilities with remote possibility of occurrence, for the current year and the last year.
- Description of fundamentals considered in order to disclose this information in notes, based on the significant risks and uncertainties.
- The assertion that these amounts are not considered as provisions and they are not considered as contingent liabilities according to International Accounting Standard 37.

the concerned information has not been disclosed.

23 A disclosure example of incidental liabilities with remote possibility of occurrence, proposed by this standard, is presented next:

7) *Note X) Incidental Liabilities With Remote Possibility Of Occurrence*

As a result of taking exhaustively into account the risks that the company may face in the future, liabilities arising out of such fortuitous events would have the following impact on assets to the balance sheet date:

The incidental liabilities with remote possibility of occurrence are not considered as provisions and are not considered as contingent liabilities, both recognized and disclosed by the entity. In addition, the incidental liabilities with remote possibility of occurrence have been estimated considering the effects of events after the balance sheet date. In the opinion of the company, if the related risks eventually occur in the future, they may have significant impact in the entity.

The following describes the risks that have originated the amounts referred in this note:

**Incidental liabilities with remote possibility of occurrence**

Million dollars

	Total assets		Assets on risk in case of events with remote possibility		Risk-free assets	
	20X8	20X9	20X8	20X9	20X8	20X9
Cash and equivalents	10	8	1	1	9	7
Accounts receivables	10	11	2	1	8	10
Inventory	10	15	1	1	9	14
Property, plant and equipment	10	11	4	4	6	7
Intangible assets	10	9	1	1	9	8
<b>Total assets</b>	<b>50</b>	<b>54</b>				
<b>Incidental liabilities with remote possibility of occurrence</b>			<b>9</b>	<b>8</b>		
<b>Risk-free assets</b>					<b>41</b>	<b>46</b>

- The assertion that these amounts have been considered taking into account the fundamentals according to the International Accounting Standard 10 referred to events after the balance sheet date.

22 In extremely rare cases, disclosure of some or all the information required by paragraphs 20-21 can be expected to prejudice seriously the position of the entity in a dispute with other parties on the subject matter of the incidental liabilities with remote possibility of occurrence. In such cases, an entity need not disclose the information, but shall disclose the general nature of the dispute, together with the fact that, and reason why,

*Cash and cash equivalents:* This amount represents the operational risk resulting from the inability to secure the office staff in places like Haiti, Sudan and Afghanistan, in the absence of coverage in these areas.

*Accounts receivable:* This amount corresponds to the market risk on accounts receivable from customers located in certain zones in the United States, Israel, Iran and North Korea, countries which in case of war, our clients located in those places could be declared in payment suspension status.

*Inventories:* This amount corresponds to the political risk related to our inventories that are located in some countries in Latin-America, Asia and Africa, with the



possibility of its seizure by the respective governments due to matters related to high levels of corruption and therefore, there is a high risk of loss of ownership of such inventories.

*Property, plant and equipment:* This amount corresponds to the natural risk for the machinery and equipment located in our facilities on the coasts of several places in the south east of Asia, which are exposed to an imminent risk in the event of a tsunami, hurricane or severe natural disaster due to the effects caused by climate change.

*Intangible assets:* This amount corresponds to the political risk that could affect the value of our brands registered in countries located in Latin-America, Asia, Middle East and North Africa, which in remote cases these brands are susceptible to be canceled by undemocratic regimes established in some places of the referred continents.

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