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Contingencies

1. In the preparation of financial statements presenting financial position or operating results, or both, it is necessary to give consideration to contingencies. In accounting a contingency is an existing condition, situation or set of circumstances, involving a considerable degree of uncertainty, which may, through a related future event, result in the acquisition or loss of an asset, or the incurrence or avoidance of a liability, usually with the concurrence of a gain or loss. A commitment which is not dependent upon some significant intervening factor or decision should not be described as a contingency.

DISCUSSION

2. The contingencies with which this bulletin is primarily concerned are those in which the outcome is not sufficiently predictable to permit recording in the accounts, but in which there is a reasonable possibility of an outcome which might materially affect financial position or results of operations. Examples of contingencies which may result in the incurrence of liabilities, or in losses, are pending or threatened litigation, assessments or possible assessments of additional taxes, or other claims such as renegotiation refunds, that are being or would be contested, guarantees of indebtedness of others, and agreements to repurchase receivables which have been sold. Examples of contingencies which may result in the acquisition of assets, or in gains, are claims against others for patent infringement, price redetermination upward and claims for reimbursement under condemnation proceedings. Material contingencies of the types discussed in this paragraph should be disclosed.

3. Other contingencies may exist where the outcome is reasonably foreseeable, such as probable tax assessments which will not be contested, or anticipated losses from uncollectible receivables. Contingencies of this type which are expected to result in losses should be reflected in the accounts. However, contingencies which might result in gains usually are not reflected in the accounts since to do so might be to recognize revenue prior to its realization;[1] but there should be adequate disclosure.

4. There are also general risk contingencies that are inherent in business operations and which affect many if not all companies, such as the possibility of war, strike, losses from catastrophies not ordinarily insured against, or a business recession. Contingencies of this type need not be reflected in financial statements either by incorporation in the accounts or by other disclosure.[2]

DISCLOSURE

5. Disclosure of contingencies referred to in paragraph 2 should be made in financial statements or in notes thereto. The disclosure should be based as to its extent on judgment in the light of the specific circumstances and should indicate the nature of the contingency, and should give an appraisal of the outlook. If a monetary estimate of the amount involved is not feasible, disclosure should be made in general terms describing the contingency and explaining that no estimated amount is determinable. When amounts are not otherwise determinable, it may be appropriate to indicate the opinion of management or counsel as to the amount which may be involved. In some cases, such as a law suit involving a substantial amount, management may reasonably expect to settle the matter without incurrence of any significant liability; however, consideration should be given to disclosing the existence of the litigation and the opinion of management or counsel with respect thereto. Although disclosures discussed here should be made with respect to those contingencies which may result in material gains or assets as well as with respect to those which may result in material losses or liabilities, care should be exercised in the case of gains or

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[1] See Chapter 1, Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins.*

[2] For the committee's position with respect to contingency reserves, see Chapter 6 of Accounting Research Bulletin No. 43.

assets to avoid misleading implications as to the likelihood of realization. The discussion in this bulletin does not deal with the question as to whether the existence of any of the contingencies discussed above is such as to require a qualified opinion or a disclaimer of an opinion by the independent certified public accountant.

6. Certain other situations requiring disclosures have sometimes inappropriately been described as though they were contingencies, even though they are of a nature not possessing the degree of uncertainty usually associated with the concept of a contingency. Examples are unused letters of credit, long-term leases, assets pledged as security for loans, pension plans, the existence of cumulative preferred stock dividends in arrears, and commitments such as those for plant acquisition or an obligation to reduce debts, maintain working capital, or restrict dividends. While some of these situations may develop into contingencies, they should not be described as contingencies prior to such eventuality.

The statement entitled "Contingencies" was adopted unanimously by the twenty-one members of the committee, of whom two, Messrs. Bedford and Halvorson, assented with qualification.

Mr. Bedford objects to the provision in paragraph 3 that anticipated losses due to a contingency should be recognized in an accounting period prior to the actual incurrence of the loss. He believes that such deductions from revenue, in order to match adequately costs and revenues, should be based upon sufficient statistical evidence or experience to justify an accounting treatment different from that afforded gains. Without the sufficient statistical evidence or experience and without evidence to indicate a loss has been incurred, he believes a contingent loss should be disclosed in such a manner as not to require the recognition of the loss until the loss has been incurred.

Mr. Halvorson believes the bulletin fails in the essential matter of definition in the second sentence of paragraph 1. He feels that "a considerable degree of uncertainty" is beside the point, and that the definition as it stands would not exclude many types of commitments. He believes that the point should be that the "existing condition" and the "related future event" would affect present financial position or present or past operations, and would be so recorded in the statements, if all the uncertainties could be resolved at the time the statements are being issued. He also believes that the bulletin should not deal with the "general risk" contingencies described in paragraph 4, as they are not of a peculiarly accounting nature, and the attempt to accommodate them in an accounting bulletin has required a definition that is so broad as to fail in its purpose.

NOTES

(See Introduction to *Accounting Research Bulletin* No. 43.)

1. Accounting Research Bulletins represent the considered opinion of at least two-thirds of the members of the committee on accounting procedure, reached on a formal vote after examination of the subject matter by the committee, the technical services department, and the director of research. Except in cases in which formal adoption by the Institute membership has been asked and secured, the authority of the bulletins rests upon the general acceptability of opinions so reached.

2. Opinions of the committee are not intended to be retroactive unless they contain a statement of such intention. They should not be considered applicable to the accounting for transactions arising prior to the publication of the opinions. However, the committee does not wish to discourage the revision of past accounts in an individual case if the accountant thinks it desirable in the circumstances. Opinions of the committee should be considered as applicable only to items which are material and significant in the relative circumstances.

3. It is recognized also that any general rules may be subject to exception; it is felt, however, that the burden of justifying departure from accepted procedures must be assumed by those who adopt other treatment. Except where there is a specific statement of a different intent by the committee, its opinions and recommendations are directed primarily to business enterprises organized for profit.