

# Contingencies

## Accounting 422/522

This is a very important area, and was the subject of one of the very first new standards by the FASB:

FAS 5. Original documents are:

FAS 5 as originally issued: <http://fasb.org/pdf/fas5.pdf>

FAS 5 as amended: [http://fasb.org/pdf/aop\\_FAS5.pdf](http://fasb.org/pdf/aop_FAS5.pdf)

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A contingency is a possible future event **B** (either a payment or receipt of cash or service) whose occurrence depends on whether some condition **A** comes to pass. In other words, if **A** happens, then **B** is sure to follow. We are concerned about the proper accounting for **B**.

An example helps make everything clear. Imagine that it is winter in Bowling Green. Conditions are nearly *white-out*. A downtown store is open. Customers have been tracking in snow and ice, which has melted and has pooled on the aisle floor. A particular customer falls while walking through the slippery pool, and lands in a terrible crash. After helping said customer get up, an angry outburst is followed by the threat, "You'll hear from my lawyer!"

At this point, no liability exists for certain, because it has not yet been determined if the store will actually need to pay any money. However, there is a contingent liability. *If A*: an adverse judgment is levied against the store after the customer's lawyer files a lawsuit, *then B*: the store will need to pay some monetary damages.

The accounting for contingency **B** depends on the likelihood of condition **A**.

### Contingent Liability

**A** is probable or expected

Report **B** on balance sheet & income statement if the amount can be estimated. Debit loss and credit estimated liability. Only disclose in notes to financial statements if amount is too uncertain to be estimated.

**A** is reasonably possible, maybe or maybe not

Only disclose **B** in notes to financial statements

**A** is remote, unlikely and would surprise

No disclosure at all.

Generally speaking, lawsuits are classified as reasonably possible, because actively contesting a lawsuit means that a company hasn't given up hope of winning. There is always a chance that a judge or jury will decide in a company's favor. When appealing an adverse judgment, then the contingency is classified as probable.

## Contingent Receivable

A likelihood is probable	Only disclose <b>B</b> in notes to financial statements
A likelihood is reasonably possible	Only disclose <b>B</b> in notes to financial statements
A likelihood is remote	No disclosure at all.

Even if a contingent receivable can be estimated and probable, don't report it on the face of the financial statements, nor make an entry booking the gain. Why? Because revenue recognition principle says not to book gains until they actually occur.

The comment period for a proposed amendment just ended, but the FASB has not yet met to decide if the proposed amendment should be enacted. The proposal deals with contingent liabilities related to lawsuits. The defendant company is to estimate and disclose the amount likely to be paid out as a result of the lawsuit, even if it is actively being contested. This is very controversial because (1) if the company estimates a too-low amount and eventually loses a larger amount, then shareholders have a slam dunk case against the company for improper and misleading disclosure, and (2) litigant lawyers can argue for a favorable judgment and damages because the defendant company have in effect admitted guilt by disclosing its estimated loss amount. The exposure draft can be downloaded at [http://fasb.org/draft/ed\\_contingencies.pdf](http://fasb.org/draft/ed_contingencies.pdf)

The following is taken from the 2007 10-K for IDEARC Inc., for the fiscal year ended 12/31/06. IDEARC has the second largest paper yellow pages directory and the largest online yellow pages directory.



### Note 18 Contingencies

#### Litigation

The Company is subject to various lawsuits and other claims in the normal course of business. In addition, from time to time, we receive communications from government or regulatory agencies concerning investigations or allegations of noncompliance with laws or regulations in jurisdictions in which we operate.

We establish reserves for specific liabilities in connection with regulatory and legal actions that we deem to be probable and estimable. No material amounts have been accrued in our financial statements with respect to any matters. In other instances, including the matters described below, we are not able to make a reasonable estimate of any liability because of the uncertainties related to the outcome and/or the amount or range of loss. We do not expect that the ultimate resolution of pending regulatory and legal matters in future periods, including the matters described below will have a material effect on our financial condition or results of operations.

We are currently subject to a class action lawsuit and a purported class action lawsuit from current and former sales representatives located in California, New York, Pennsylvania and New Jersey. The plaintiffs in these cases claim that we reduced their incentive pay through offsets for cancellations, non-renewals and credits on customer accounts and shifted a general business risk of loss to our sales representatives through the assignment of accounts which we allegedly knew would not renew their purchases, or would renew them at a lower level. The plaintiffs seek amounts that they allege were unlawfully deducted from their wages, civil penalties, interest, attorneys' fees and costs. Some of the plaintiffs also seek amounts for overtime they allege they worked for which they were not paid. These cases are at varying stages of defense and the ultimate outcome is not determinable.

We are subject to an alleged patent infringement action that was filed on November 15, 2006, with the U.S. District Court for the Eastern District of Texas. The plaintiff, an English Wales corporation, filed its complaint alleging that it is the owner of U.S. Patent No. 5,930,474 entitled "Internet Organizer for Accessing Geographically and Topically Based Information." Plaintiff claims that the defendants' Superpages.com site utilizes technology that infringes its patent and that the defendants, through their agents and employees have induced the infringement or contributory infringement of the patent. Plaintiff seeks an order from the court that finds that the defendants infringed the patent, injunctive relief, and monetary damages. Defendants' filed a responsive pleading to the complaint on February 9, 2007. The ultimate outcome of this case is not determinable.