Bookkeeping Tips

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Contingent Liabilities

Liabilities that involve uncertainty about the future are known as *contingent liabilities.* A *contingency* is a future event that may or may not occur.

Loss contingencies are based on future events that may result in a loss or in the use of a firm's resources, such as lawsuits, insurance and casualty risks, product warranties, discount coupons, and premium offers to customers.

Gain contingencies are based on future events that may result in the receipt of cash or other assets or reduction of a firm's liabilities, such as from lawsuits where the firm expects a favorable settlement—but these are rare.

Conservatism (the income statement and balance sheet should not overstate a company's financial position) often requires recognition of loss contingencies but rarely gain contingencies. Such liabilities are generally year-end adjusting entries that debit an expense account and credit a liability account by the amount the firm "reasonably estimates" it will "probably" lose.

Accounting for contingent liabilities is governed by the Financial Accounting Standards Board's Statement of Financial Accounting Standard No. 5 (SFAS No. 5), *Accounting for Contingencies*, which requires that future events be grouped into one of three categories:

1. A probable loss is one that is both *probable* and *can be reasonably estimated*, and it must be recorded. "Probable" generally means that the loss is likely to require future consumption of the firm's resources; that management expects subsequent events to confirm the liability so that formal recognition of the loss is a better reflection of a firm's obligations than nonrecognition.

2. If it is "reasonably possible" that a loss will occur, "full disclosure" requires a footnote to the balance sheet giving the details that the firm knows about the contingency and, if available, the estimated amount, or if a single estimate is unavailable, a range of estimates.

Sample footnote: "The firm is a defendant in a lawsuit filed by a competitor claiming damages of $x million. Our legal counsel does not think it probable the suit will go to trial and that there will be an out-of-court settlement. It is not possible to estimate the amount of such a settlement at this time."

3. If the chances of a loss are "remote," e.g., a frivolous lawsuit that has little chance of harming a firm, the contingency need not be reported on the financial statements. But remote contingencies must be reported for bank obligations related to letters of credit, receivables repurchase guarantees, and guarantees of other parties' indebtedness.

SFAS No. 5 spells out when a loss contingency should be *recorded* as a liability on the balance sheet and an expense on the income statement; when it should be *disclosed* through a footnote in the financial statements; and when it should be *ignored* for financial reporting purposes.

Banks, creditors and investors may be at risk when contingent liabilities are not disclosed and may act to protect themselves if they think they have been deceived.

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The American Institute of Professional Bookkeepers (AIPB), is the national association for bookkeepers, currently with 30,000 active members

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- To recognize bookkeepers as accounting professionals
- To make sure that each member has the latest bookkeeping, accounting and tax information
- To answer members' everyday bookkeeping and accounting questions on the telephone at no charge.
- To provide bookkeepers with low-cost continuing professional education.
- To return the membership fees of any bookkeeper who is dissatisfied with the benefits of membership