Re: Accounting for Contingencies

Accounting for contingencies is a very important topic because of the amount of money involved in potential lawsuits can then be used to manipulate balance sheets for many companies. These lawsuits can greatly impact a company’s financial position and income as well as leverage for investors and creditors. With more regulation and hard controls, the temptation to manipulate financial statements can be reduced, if not eliminated.

Usually in accounting, the financial statements are very conservative. When accounting for contingencies though, the accounting is a different story. The idea that a lawyer gets to decide if the company will get sued and win or lose is important because what goes on the financial statements is dependent on the lawyer’s opinion as well as competency. An important factor when deciding the range of loss of a contingency to be recorded on the financial statements is the amount the company choses to disclose. For many years, accounting has been considered to be conservative but when contingent liabilities are being decided, the company picks the lower amount, which is not the most conservative. This adds more uncertainty to determine when a liability should be reported, and/or recognize. According to FASB, when a contingent liability is estimated and probable, then it would go on the company’s books. When the liability is only possible and/or the amount cannot be estimated, it does not go on the books, but rather disclosed in the footnotes. When the liability is remote, it does not even get disclosed at all.

The idea behind the contingent liabilities and how it is decided if something is probable, possible, or remote is based on the lawyers discretion but this allows a lot of room for making the numbers in the financial statements what a company wants them to be. If a company is having a good year and wants to look better for investors and creditors, they may lean more toward considering the liability to be remote and not even disclose a potential lawsuit so no one sees the liability. On the other hand, if a company wants to look worse, they may just recognize all potential liabilities whether they are probable, or even remote.

If FASB decides to continue with the idea of contingent liabilities in this way then the idea of possibly having contingent assets should be a thought. If a company is going to sue another company and probably win, then there should be a contingent asset similar to how the contingent liability works. While this allows more room for
manipulation, it also makes it fair that this information is shared because of the possibility of success.

With any, or all of the options, the financial statements can be more accurate and allow for less room for error, while being accepted by companies that submit financial statements for investors, which is always the goal of GAAP. If accounting standards, such as contingencies, are made into a strict guideline, then all financial statements can be read and translated easier for current and future investors and creditors so they know more accurately where their money is going and can invest and lend money with confidence.

Sincerely,

Michael Post