

Week 4 - DQ 2

What is a contingency?

Why are contingencies important to users of financial statements?

What are the criteria for recording contingencies?

Should companies record a liability for threatened litigation? Explain why or why not.

Response #1 A contingency is an existing condition, situation, or set of circumstances involving uncertainty as to possible gain or loss to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. Users of financial statements use this information to determine the future of the company, whether it faces some positive or negative impacts. Gain contingencies are not usually reported, unless the contingencies are tax loss carry-forwards. If high probability exists for realizing the gain, only then are they only noted. Loss contingencies should be reported if the following conditions are met: first, the amount of loss can be reasonably estimated, and second, the information available prior to the issuance of the financial statements indicates that it is probable that a liability has been incurred at the date of the financial statements. Organizations should consider some factors in determining whether to record a liability with actual or possible claims and assessments, and pending or threatened litigation: the probability of an unfavorable outcome, the ability to make a reasonable estimate of the amount of loss, and the time period in which the underlying cause of action occurred. However, it is very difficult to predict the outcome of litigation with any assurance. Consequently, the organization should publish a dollar estimate of the probable negative outcome in its financial statements.

Response #2 A contingency is when there is uncertainty of an outcome of a situation. A contingency plan should be in place in case something should go wrong with a plan. Contingencies are important to users of financial statements because the investors within a company should be aware of any financial uncertainty of activities within the company. Companies should record a liability for threatened litigation if the company feels that the litigation would be favorable for a loss to the company so the funds will be available if needed.

Response #3 A contingency is an existing situation, condition, or set of circumstances that have uncertainty that a gain or loss to a company will be resolved if a future event(s) happens or does not happen. There are gain contingencies, which are claims or rights to receive assets, and loss contingencies, which contain the risk of losses. Contingencies are important to the users of financial statements because they need to know the information for these probable, reasonably possible, or remote, chances of a gain or loss from a

contingency. They are using this information to make important decisions and in the interest of disclosure, the information should not be left out. Companies disclose gain contingencies in the notes of a financial statement when there is a high probability that they will be realized. This is way it is rare to see such information in the statements and notes. A firm should accrue any estimated loss from a loss contingency by charging to expense and a liability. A company must know if it is probable they incurred a liability. Companies do not report or record in financial statement notes any general risk contingencies relating to their business operations. Companies should probably recorded a liability for threatened litigation. It shows the financial statement users of the risk of a loss contingency. It is up to the company to determine the time of the action, probability of an unfavorable outcome, and have a good estimate of any loss, when reporting this information in financial statements.

Reference: *Kieso, D.E., Weygandt, J.J., & Warfield, T.D. (2007). Intermediate Accounting (12th ed.). Hoboken, NJ: John Wiley & Sons.*

Response #4 A contingency is an existing situation that involves uncertainty of a loss or gain that will not be resolved until further future events occur or fail to occur. Contingencies are important to users of financial statements because contingencies may become valid eventually and users can make more informed decisions if they know of these possibilities. Since the events haven't been resolved yet, they are not recorded in the financial statements, but they are material enough that the users need to be informed. Gain contingencies are not recorded but are disclosed in the financial notes. Companies accrue estimated loss from a loss contingency if it is probable that the liability will occur and if the amount of loss can be reasonably estimated. If a threatened liability is probable, the loss can be reasonably estimated, and the cause of action occurred before the statement date, then the liability should be accrued.