Audit Insights

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Contingent liabilities: To report or not to report?

Disclosure of contingent liabilities — such as those associated with pending litigation or government investigations — is a gray area in financial reporting. It's important to keep investors and lenders informed of risks that may affect a company's future performance. But companies also want to avoid alarming stakeholders with losses that are unlikely to occur or disclosing their litigation strategies.

Understanding the GAAP requirements

Under Accounting Standards Codification (ASC) Topic 450, *Contingencies*, a company is required to classify contingent losses under the following categories:

Remote. If a contingent loss is *remote*, the chances that a loss will occur are slight. No disclosure or accrual is usually required for remote contingencies.

Probable. If a contingent loss is *probable*, it's likely to occur and the company must record an accrual on the balance sheet and a loss on the income statement if the amount (or a range of amounts) can be reasonably estimated. Otherwise, the company should disclose the nature of the contingency and explain why the amount can't be estimated. In general, there should be enough disclosure about a probable contingency so the disclosure's reader can understand its magnitude.

Reasonably possible. If a contingent loss is *reasonably possible*, it falls somewhere between remote and probable. Here, the company must disclose it but doesn't need to record an accrual. The disclosure should include an estimate of the amount (or the range of amounts) of the contingent loss or an explanation of why it can't be estimated.

Making judgment calls

Determining the appropriate classification for a contingent loss requires judgment. It's important to consider all scenarios and document your analysis of the classification.

In today's volatile marketplace, conditions can unexpectedly change. You should re-evaluate contingencies each reporting period to determine whether your previous classification remains appropriate. For example, a remote contingent loss may become probable during the reporting period — or you might have additional information about a reasonably possible or probable contingent loss to be able to report an accrual (or update a previous estimate).

Outside expertise

Ultimately, management decides how to classify contingent liabilities. But external auditors will assess the company's existing classifications and accruals to determine whether they seem appropriate. They'll also look out for new contingencies that aren't yet recorded. During fieldwork, your auditors may ask for supporting documentation and recommend adjustments to estimates and disclosures, if necessary, based on current market conditions. [Contact us] for more information.