

## Forensic Accounting Technical Notes: SFAS 5, "Accounting for Contingencies"

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Other than Statement of Financial Accounting Standard ("SFAS or FAS") No. 5, "Accounting for Contingencies", there is no authoritative accounting pronouncements that specifically addresses the basic generally accepted accounting principles ("GAAP") which set forth accounting for reserves and allowances. There are a few other SFAS' which implicate use of reserves or allowances, such as: FAS 48, "Revenue Recognition When Right of Return Exists" and FAS 121, "Accounting for Impairment of Long-lived Assets and Long-lived Assets To Be Disposed Of". However, it is FAS 5 which sets forth the GAAP standards for reserves and allowances.

Why is FAS 5 so important in the science of forensic accounting? Particularly in the area of securities litigation and attendant issues of accounting misstatements, many of the legal allegations and underlying accounting issues turn on the application of FAS 5. The title, "Accounting for Contingencies," may be misleading, in that it suggests something less than the concrete (if that) of historical financial information. What FAS 5 actually applies to is the carrying value of every asset and every liability included in a set of historical financial statements. Each and every asset and liability, recorded in a company's books and records at historical cost, may be subject to impairment or "loss contingency" assessed and measured under the basic guidance set forth in FAS 5. Typical examples are:

<b>Historical Cost Asset/Liability</b>	<b>"Loss Contingency" Account</b>	<b>Application</b>
Application	Allowance for Doubtful Accounts (Bad Debts)	Assessment of collectability of receivables and estimation of allowance for bad debts
Inventory	Reserve for Obsolete or Slow-moving Goods	Determination of inventory impairment and estimation of loss in value (lower of cost or of impairment)
Plant and Equipment	Reserve for Impairment of Long-lived Assets	Assessment of recovery of carrying value of fixed assets and measurement of amount of impairment
Claims Liability (e.g. - Workers' Compensation)	Self-insurance Reserve for Incurred-But-Not-Reported Losses	Actuarial assessment and measurement of future liabilities for currently incurred claims
Contingent Claims	Legal Reserves	Assessment of liability and estimation of damages

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FAS 5 defines contingency as: "... an existing condition, situation or set of circumstances involving uncertainty as to possible gain ("gain contingency") or loss ("loss contingency") to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm the acquisition of an asset, or the reduction of a liability, or the loss or impairment of an asset, or the incurrence of a liability. FAS 5, para. 4, provides examples of loss contingencies such as:

- a. Collectibility of receivables;
- b. Obligation related to product warranties and product defects;
- c. Risk of loss or damage of enterprise property by fire, explosion or other hazards;
- d. Threat of expropriation of assets;
- e. Pending or threatened liabilities;
- f. Actual or possible claims or assessments;
- g. Risk of loss from catastrophe assumed by property and casualty [insurers];
- h. Guarantees of indebtedness of others;
- i. Obligation of commercial banks under standby letters of credit; [or],
- j. Agreements to repurchase receivables (or the related property) that have been sold."

FAS 5 applies to the exemplified "a. Collectibility of receivables," but its scope also encompasses: general reserves, accruals of liabilities (including accruals of tax liabilities such as franchise tax and property tax), impairment of assets, litigation reserves, and incurrence of other obligations - such as environmental liabilities, benefits (i.e.- pension, health care, and other postretirement or post-employment), and reserves and liabilities associated with restructurings or discontinued operations.

### Basis and Derivation

Financial Accounting Standards Board Statement of Concepts ("CON") No. 5, "Recognition and Measurement in Financial Statements of Business Enterprises" sets forth the accounting concept which underpins FAS 5. CON 5, para. 87, Loss or Lack of Future Benefits states: "An expense or loss is recognized if it becomes evident that previously recognized future economic benefits of an asset have been reduced or eliminated, or that a liability has been incurred or increased, without associated economic benefits." FAS 5 supersedes Accounting Research Bulletin ("ARB") No 43, "Restatement and Revision of Accounting Research Bulletins," Chapter 6, "Contingency Reserves," and ARB No. 50, "Contingencies"

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### GAAP Accounting Standard

FAS 5 proscribes all gain contingencies, following the similar proscription in ARB No. 50, stating in FAS 5, para. 17 (a): "Contingencies that might result in a gain usually are not recognized in the accounts since to do so might be to recognize revenue prior to its realization." This also derives from the accounting postulates of conservatism and realization. CON 2, "Qualitative Characteristics of Accounting Information," defines conservatism as: "A prudent reaction to uncertainty to try to ensure that uncertainty and risks inherent in business situations are adequately considered." Accounting Principle Board ("APB") Statement 4 describes conservatism in the context of making accounting decisions as follows: "Frequently, assets and liabilities are measured in a context of significant uncertainties. Historically, managers, investors and accountants have generally preferred that possible errors in measurement be in the direction of understatement rather than overstatement of net income and net assets. However, CON 2, para. 93, goes on to state: "Conservatism...should no[t] connote deliberate, consistent understatement of net assets and profits." [Emphasis added] CON 5 describes realization in terms of recognition criteria for revenues and gains, as: "Revenue and gains generally are not recognized until realized or realizable... when products (goods or services), merchandise or other assets are exchanged for cash or claims to cash...[and] when related assets received or held are readily convertible to known amounts of cash or claims to cash....Revenues are not recognized until earned ...when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues." Almost invariably, gain contingencies do not meet these revenue recognition criteria.

FAS 5, para. 3, assigns a range of likelihood that future events will confirm the loss or impairment of an asset or incurrence of a liability as follows:

- a. Probable. The future event or events are likely to occur.
- b. Reasonably possible. The chance of the future event or events occurring is more than remote but less than likely.
- c. Remote. The chance of the future event or events occurring is slight."

FAS 5, para 8, sets forth the GAAP standard for loss contingencies as follows: "An estimated loss from a loss contingency shall be accrued by a charge to income if both of the following conditions are met: (a) information available prior to issuance of the financial statements that it is probable that an asset has been impaired or a liability has been incurred at the date of the financial statements [and] (b) the amount of loss can be reasonably estimated." Thus, the FAS 5 criteria for accruing allowances and reserves for loss contingencies are probable and estimable. FAS 5 does not assign specific ranges of chance or odds to the category probable, but practice has interpreted it to mean more likely than not, and practitioners often have equated the range to between the legal standards of by a preponderance of the evidence and clear and convincing. Where probable may lie within this range is itself a subject of reasonable judgment, based upon specific facts and circumstances of each particular loss contingency.

FAS 5 proscribes accrual of reserves for general contingencies or unspecified business risks. FAS 5, para. 30, addresses the concept of general or unspecified risk of loss, such property damage, business interruption, catastrophe, etc., and states: "Mere exposure to risks of those types, however, does not mean that an asset has been impaired or a liability has been incurred. Thus, general reserves for potential business reversals, unspecified damages, decline in business fortunes, etc., are barred by FAS 5.

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### Collateral GAAP

The scope of GAAP affected in some fashion by FAS 5 is virtually every authoritative pronouncement. However, collateral GAAP most often implicated for a typical company are:

- FAS 48 "Revenue Recognition When Right of Return Exists"
- FAS 77 "Reporting By Transferors for Transfer of Receivables With Recourse"
- FAS 121 "Accounting for Impairment of Long-lived Assets and for Long-lived Assets to Be Disposed Of"
- APB 28 "Interim Financial Reporting"
- APB 30 "Reporting the Results of Operations - Reporting the Effects of Disposal of a Segment of a Business"
- SOP 82-1 "Accounting for Performance of Construction-type and Certain Production-type Contracts"
- EITF 84-28 "Impairment of Long-lived Assets"
- EITF 86-12 "Accounting by Insureds for Claims-made Insurance Policies"
- EITF 89-13 "Accounting for Cost of Asbestos Removal"
- EITF 92-13 "Accounting for Estimated Payments in Connection with the Coal Industry Retiree Health Benefit Act of 1992"
- EITF 93-5 "Accounting for Environmental Liabilities"
- FTB 87-2 "Computation of Loss on an Abandonment"

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Relevant Audit (Accounting) Evidence and Practice

### **Allowance for Doubtful Accounts**

FAS 5, para 22, requires that: "Losses from uncollectible receivables shall be accrued when both conditions in [FAS 5] para. 8 are met [probable and estimable]. Those conditions may be considered in relation to individual receivables or groups of similar types of receivables. If the conditions are met, accrual shall be made even though the particular receivables that are uncollectible are may not be identifiable. That is, the allowance for doubtful accounts is fungible and applicable to the balance of receivables as a whole. FAS 5, para. 23 sets forth some of the evidential considerations to be used in establishing an allowance for doubtful accounts, as follows:

- Experience of the enterprise [with prior uncollectability of receivables] (including experience after the date of the financial statements but before such statements are issued)
- Information about particular debtors' ability to pay (i.e.- credit reports, defaults, bankruptcy, financial statements)
- Appraisal of the receivables in light of the current economic environment

### **Litigation, Claims and Assessments**

FAS 5 para. 33, sets forth the following factors which must be considered: "...(a) the period in which the underlying cause (i.e.- the cause of action) of the pending or threatened litigation or of the actual or possible claim or assessment occurred; (b) the degree of probability of an unfavorable outcome; [and] the ability to make a reasonable estimate of the amount of loss." FAS 5, para.36 sets forth some of the evidential considerations to be used in determining whether to establish a litigation or claims reserve (and in determining the amount of such a reserve):

- Nature of the litigation or claim
- The progress of the matter (including progress and status after the financial statement date but before the financial statements are issued)
- The opinions or views of legal counsel [usually in accordance with ABA Statement 5 and in response to a request for legal representations "legal letter" made by the entity, on behalf of (and to be addressed to) the entity's independent auditors]
- Opinions and analyses of other advisors or specialists (e.g.- environmental engineers, asbestos removal contractors, claims adjusters, actuaries, litigation consultants, economists, valuers or appraisers, etc.)
- Experience of the entity with similar cases or matters
- Experience of other enterprises with similar cases or matters (including precedent in other cases of a similar nature)
- Management' intentions as to the entity's response to the litigation, claim or assessment (i.e.- to contest the matter vigorously or to seek an out-of-court settlement)

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### **Tax Accruals**

Property tax, franchise tax and state taxes (e.g.- "single business" tax, income tax, etc.) are subject to the same criteria of FAS 5 - probable and estimable. Contingencies arise in the implementation of tax strategies, or positions taken in respect to interpretation of tax laws, which may entail risk of tax litigation, claims or assessments - and resultant increase in tax liabilities. Tax accruals often include a reserve component (sometimes referred to as "cushion") to provide for such contingencies. The evidential considerations are similar to those set forth above under Litigation, Claims and Assessments.

### **Long-lived Asset Impairments and Discontinued Operations**

FAS 121 prescribes GAAP standards for impairment of long-lived assets. APB 30 addresses accounting for discontinued operations. Both require comparison of the fair value of the asset to its carrying (net book value), giving effect to the costs of disposal, abandonment or restructuring, and loss recognition for any excess of carrying value over fair value. FAS 121, para 7, sets forth criteria for measurement of impairment, including:

- Quoted market prices in active markets
- Prices for similar assets
- Present value of projected future cash flows, using a discount rate commensurate with the risk involved
- Option pricing or matrix pricing models
- Objectively verifiable assumptions underlying projected cash inflows and outflows

APB 30, paras 16 and 17, requires recognition of costs directly associated with an applicable asset disposition, such as:

- Severance pay
- Additional pension [and other benefits] costs
- Employee relocation [re-training, out-placement, or counseling] expenses
- Future rentals on long-term leases (to the extent not offset by sub-leases) [and other future contractual obligations]
- Write-downs or write-offs of receivables, inventory or other assets directly the the consequence of the disposition [and not due to ordinary course events]

### **General Evidential Considerations**

SAS 57 establishes criteria for reasonable estimate(s), and these include: (1) identification (and articulation) of the need for such estimate(s) to be made; (2) development of the estimate(s) based upon (a) known or knowable economic and financial evidence in existence at the time of the estimate, (b) experience with prior actual results, and (c) consideration of other factors (i.e.- management plans, business conditions and exogenous factors); (3) a system of controls and procedures designed to develop, monitor and adjust estimates made; and, (4) management judgments which are conservative, reasonable in the circumstances and subject to continuing reassessment and re-calibration based upon: (a) subsequent actual-to-estimate results, (b) changes in circumstances, and (c) changes in external factors.

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### Relevant Audit (Accounting) Evidence

- Control structure: (1) policies and procedures setting forth estimates to be made, estimation methodologies, accounts to be used, estimation responsibilities and authorities, review procedures, and procedures to be followed for adjustments and revisions; (2) procedures and practices defined as to FAS 5 determinations of probable and estimable; (3) segregation of duties and a structure designed to review estimates for reasonableness; (4) identification of specific estimates to be made; (5) documentation of support for and computation of estimates; (6) procedures for developing audit evidence (i.e.- prior actual experience, contractual terms, current economic and financial facts); and, (7) a system for comparing estimates to subsequent actual results and revising such estimates accordingly.
- Underlying support for existence of obligation: (1) contract abstracts or precis; (2) current and projected future liability/ cost data (i.e.- payroll, headcount, benefits costs, terms of payments); (3) actuarial data; (4) prior claims histories; (5) termination and post-employment plans and agreements; (6) documentation of management decisions and authorizations (e.g.- board minutes, memoranda, contractual agreements, etc.); (7) actuarial reports (and reports of other specialists); (8) legal letters and other evidence of legal interpretation; and, (9) documentation of management judgments.
- Documentation of computation and accounting for estimates: (1) trial balances and general ledger accounts setting forth estimation (i.e.- reserves) accounts; (2) journal entries with supporting documentation for their bases; (3) computational working papers, analyses and schedules; (4) reference to, or inclusion of, objective economic, financial and accounting data; and, (5) evidence of review and authorization.
- Systematic monitoring and assessment of estimates: (1) accumulation and measurement of previous and subsequent actual results; (2) comparison of actual- to-estimate results and analysis of variances; (3) monitoring and factoring of subsequent changes in external factors, management plans and business circumstances; and, (4) adjustment of prior estimates based upon objectively determinable changes in circumstances.