

## ***Legal Letters and Contingencies***

### **Background**

As indicated in our “Commitments and Contingencies” policy (L-CC-00-2040-1), legal contingencies are accrued for if the contingency is considered probable of loss (i.e. there is a 70% chance or better that the loss will be incurred) and the amount can be reasonably estimated. If losses are reasonably possible, (generally between 5% and 70%), an accrual is not made, but the amount is considered for disclosure in the financial statements. If losses are remote (generally less than 5% change), no accrual or disclosure is made. Accountants often require input from legal counsel in order to determine the proper accounting for a contingency. The primary purpose of the legal letter is to ascertain a legal conclusion as to the probability of loss. A legal letter provided to one of our subsidiaries provided the following conclusion:

“We believe that there are possible chances of a successful outcome in relation to the fine and interest and remote chances in relation to the principal.”

It is not possible to accurately determine the appropriate accounting as described above if a legal letter is stated in probabilities of success. For example, in the situation above, the lawyer indicated that the chances of a successful outcome in relation to the principle was remote, meaning there was less than a 5% chance we would win, or when we review it from a loss standpoint, there was a 95% chance we would lose. This portion of the analysis would be easily translated to indicate we would need to accrue for this amount because the probability of loss is greater than 70%. However, the lawyer then indicated that there was a possible chance of success related to the fine and interest. This possible chance of success would mean there is somewhere between a 5% and 70% chance of success, or when we review it from a loss standpoint, there could be a 30% - 95% chance of loss. This makes it difficult to analyze from an accounting standpoint because these percentages fall within both the probable of loss definition and the reasonably possible of loss definition.

As the letter addressed the probability of success, instead of the probability of loss, a revised analysis had to be requested from the lawyers to support the accrual. The revised analysis was as follows:

“Considering chances of loss, the rate is possible chances of loss in relation to the fine and interest and probable chances of loss in relation to the principal.”

**Lesson Learned**

The lesson to be learned is that accountants reviewing legal letters should ensure the lawyers have provided an analysis of the probability of loss. Conclusions must enable the accountant to determine whether the loss is probable and must be accrued, or is reasonably possible, and may then be evaluated for disclosure.