

The auditing firm of Rosellini and Rossellini was auditing the year-end financial statements of its client, City Center Foods. In the course of the audit, it was discovered that City Center was the defendant in a law suit involving a "food poisoning" case. City Center denies that it sold any tainted food products. City Center's attorney provided a representation letter regarding the ongoing litigation. Following is a portion of the reply received from the attorney:

Dear Ms. Rossellini:

You requested that we furnish you with certain information in connection with your examination of the accounts of City Center Foods, as of December 31, 20X7 . . .

While this firm represents City Center Foods, our engagement has been limited to specific matters involving the ongoing litigation between City Center Foods and Randal Ransom. This response is necessarily limited to those matters. The Company has advised us it does not intend to waive the attorney-client privilege with respect to any information which the Company has furnished to us. Moreover, please be advised that our response to you should not be construed in any way to constitute a waiver of the protection of the attorney work-product privilege with respect to any of our files involving the Company.

In the matter of Randal Ransom v. City Center Foods: On June 30, 20X7, Randal Ransom filed a civil action in Federal District Court for the Eastern District of Texas alleging that he was significantly damaged by consumption of food products sold by City Center Foods. He further alleges that City Center Foods knowingly sold such food products and failed to maintain appropriate refrigeration equipment. Mr. Ransom is requesting specific damages of \$1,000,000 and such additional amounts as may be awarded by a jury.

This litigation is in its earliest stages, and discovery is not yet complete. At this stage of litigation, it is impracticable to render an opinion about whether the likelihood of an unfavorable outcome is either "probable" or "remote;" however, the Company believes it has meritorious defenses and is vigorously defending this litigation . . .

Robert Bean, Attorney

- (a) What is a contingent liability?
- (b) What criteria drive the determination of when/how a contingency should be reported?
- (c) How do you believe the litigation described in the attorney's letter should be reported?