



Current Liabilities and Contingencies

15.511 Corporate Accounting
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Agenda

- Nature and reporting of current liabilities
- Understand the nature and reporting requirements of contingencies
- Illustrate the trade-off between reliability and relevance in accounting for contingencies



Liabilities and Off Balance Sheet Financing

- What is the definition of liabilities in GAAP?
 - Probable future sacrifices of resources
 - Little or no discretion to avoid the sacrifice
 - Transaction or event giving rise to the obligation has occurred
- Classification on a continuum
 - On Balance sheet
 - Off Balance sheet
- Motivation for off balance sheet financing?



Examples of Liabilities and Off Balance Sheet Financing

- Bonds, notes payable
- Accrued wages, supplier finance
- Warranty obligation
- AAA receives \$ from the sale of memberships for the next two years
- Columbia pictures signs a binding contract with Cineplex Odeon to supply films within the next six months.
- Online Corp. signs a contract promising to employ its president for the next five years for a salary of \$1m per year.
- Citibank extends a line of credit for one of its major corporate clients.



Examples of Liabilities and Off Balance Sheet Financing

- ChevronTexaco Corp. signs a throughput contract with an oil pipeline company to ship at least 10,000 barrels of crude oil per month for the next three years. ChevronTexaco promises to pay for the pipeline services even if it does not ship oil.
- Alcoa of Australia (AofA) is party to a number of natural gas and electricity contracts that expire between 2002 and 2020. Under these take-or-pay contracts, AofA is obligated to pay for a minimum amount of natural gas or electricity even if these commodities are not required for operations.
- Boise Cascade and Georgia-Pacific start a joint venture to process pulp. The joint venture uses the purchase commitments of Boise Cascade and Georgia-Pacific to obtain a loan for the facility.
- Seagram 'sells' aging whiskey to its bank to obtain financing for its production process. After the aging process, Seagram arranges for others to purchase the whiskey and remits the proceeds to the bank.



Warranty liabilities

- Warranty liability

- Seller provides a warranty for service and/or repairs for a specified period after sale
- Sales price includes the warranty
- Liability recognized at the time of sale
- Estimated cost of providing the warranty is recognized as an expense

Dr Cash or receivables (+A)

Dr Warranty expense (- Income statement or -RE)

Cr Sales revenue (+ Income statement or + RE)

Cr Warranty liability (+Liability)



Warranty liabilities: Problem 9-23

- (See Problem 9-23 on page 522 of the course textbook: Stickney, Clyde P., and Roman L. Weil. *Financial Accounting: An Introduction to Concepts, Methods, and Uses*. 10th ed. Thomson South-Western, 2003. ISBN: 0324183518.)



Contingencies

A **Contingency** is defined as

“... an existing condition, situation or set of circumstances involving uncertainty as to the possible gain (hereinafter, a gain contingency) or a loss (hereinafter, a loss contingency) to an enterprise that ultimately will be resolved when one or more future events occur or fail to occur.”

Resolution of uncertainty

Gain contingency

Acquisition of asset
Reduction of liability

Loss contingency

Loss or impairment of asset
Incurrence of liability



Accounting guidelines on contingencies

The accounting treatment of a contingency depends on whether the contingency is:

Probable - the future event is likely to occur

Reasonably possible - the chance of occurrence of the future event (or events) is more than remote but less than likely

Remote - the chance of occurrence of the future event (or events) is slight

In addition, the amount of the gain or loss must be **reasonably estimable**.



Loss Contingencies

	Measurable	Not Measurable
Probable	Accrue	Disclose in notes
Reasonably possible	Disclose in notes	Disclose in notes
Remote	None required, but note permitted	

Accrual of loss contingency:

$$\begin{array}{rcccl}
 \mathbf{A} & = & & \mathbf{L} & + & & \mathbf{E} \\
 & & & \text{Accrued liability} & & & \text{(Loss on Contingency)}
 \end{array}$$

Dr Loss on contingency (income statement)	XX	
Cr Accrued liability (balance sheet)		XX



Gain contingencies

	Measurable	Not Measurable
Probable	Disclose	Disclose, but avoid misleading inferences
Reasonably possible	Disclose but avoid misleading inferences	
Remote	Disclosure is not recommended	



Disclosure: An Example

**See Note 12, “Antitrust Investigation and Related Litigation”
from Archer Daniels Midland Company’s *Annual Report 2002*.**