



# Current Liabilities and Contingencies

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**15.511 Corporate Accounting**  
Summer 2004

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**July 1, 2003**





# Agenda

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- 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

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- 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

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- 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

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- 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

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- 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

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- Global Motors Corp
- (See.....)



# Contingencies

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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

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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

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|                            | <b>Measurable</b>                 | <b>Not Measurable</b> |
|----------------------------|-----------------------------------|-----------------------|
| <b>Probable</b>            | Accrue                            | Disclose in notes     |
| <b>Reasonably possible</b> | Disclose in notes                 | Disclose in notes     |
| <b>Remote</b>              | 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

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|                            | <b>Measurable</b>                        | <b>Not Measurable</b>                     |
|----------------------------|--|---|
| <b>Probable</b>            | Disclose                                 | Disclose, but avoid misleading inferences |
| <b>Reasonably possible</b> | Disclose but avoid misleading inferences |   |
| <b>Remote</b>              | Disclosure is not recommended            |   |



# Disclosure: An Example

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## **Archer Daniels Midland Company, Annual Report 2002**

### NOTE 12 -Antitrust Investigation and Related Litigation

The Company, along with other domestic and foreign companies, was named as a defendant in a number of putative class action antitrust suits and other proceedings involving the sale of lysine, citric acid, sodium gluconate, monosodium glutamate and high fructose corn syrup. These actions and proceedings generally involve claims for unspecified compensatory damages, fines, costs, expenses and unspecified relief. The Company intends to vigorously defend these actions and proceedings unless they can be settled on terms deemed acceptable by the parties. These matters have resulted and could result in the Company being subject to monetary damages, other sanctions and expenses.

The Company has made provisions to cover the fines, litigation settlements and costs related to certain of the aforementioned suits and proceedings. The ultimate outcome and materiality of other putative class actions and proceedings, including those related to high fructose corn syrup, cannot presently be determined. Accordingly, no provision for any liability that may result there from has been made in the consolidated financial statements.