CHAPTER 10

Introduction to Liabilities: Economic Consequences, Current Liabilities and Contingencies

SYNOPSIS

In this chapter, the author discusses (1) the economic consequences of liabilities in general and of current liabilities in particular; (2) measuring and reporting current liabilities; and (3) accounting for contingencies. The discussion on current liabilities includes accounts payable, short-term notes payable, current maturities of long-term debt, dividends payable, deferred revenues, third-party collections, and accrued liabilities. Accrued liabilities cover both determinable liabilities and conditional liabilities such as bonuses. The discussion of contingencies outlines the alternative approaches to accounting for contingencies as specified in SFAS No. 5, “Accounting for Contingencies” and the costs and benefits associated with the various alternatives. The specific types of contingencies discussed are lawsuits, environmental costs, and warranties.

The author discusses pensions and postretirement health care and insurance costs in Appendix 10A and deferred income taxes in Appendix 10B.

The ethics vignette considers a company that chooses the lower end of a range of costs when estimating the level of expense to record for contingent losses related to environmental liabilities.

The Internet research exercise examines SFAS No. 5 and how it applies to accounting for environmental costs at Waste Management.

The following key points are emphasized in Chapter 10:

1. Definition of a liability.
2. Economic consequences associated with reporting liabilities on the financial statements.
3. Determinable and contingent liabilities.
5. Bonus systems and profit-sharing arrangements and the reporting incentives they create.
6. Methods used to account for contingencies.

TEXT/LECTURE OUTLINE

Introduction to liabilities: economic consequences, current liabilities, and contingencies.

I. What is a liability? Liabilities—defined by the FASB as “probable future sacrifices of economic benefits from present obligations of a particular entity to
transfer assets or provide services to other entities in the future as a result of past transactions or events." Liabilities possess the following three characteristics:

A. Liabilities should be present obligations that will require probable future transfers or uses of cash, goods, or services.

B. Liabilities should be unavoidable obligations.

C. Liabilities must arise from a transaction or an economic event that has already taken place.

II. Reporting liabilities on the balance sheet: economic consequences.

A. Shareholders are affected by liabilities through:
   1. Seniority of interest payments over dividend payments.
   2. Debt covenants that influence investing, financing, and operating activities that a company may undertake.
   3. Seniority of creditors’ claims on assets over shareholders’ claims in the event of liquidation.

B. Creditors are concerned with:
   1. The seniority of liabilities.
   2. The presence of sufficient assets to cover liabilities.
   3. The protection of their investments through debt covenants.

C. Managers are concerned with liabilities because:
   1. Liabilities are an important source of capital for operating, investing, and financing activities.
   2. The amount of debt a company has and the ability to manage this debt affects a company’s credit rating.
   3. Debt covenants may restrict investing, financing, and operating decisions that the managers may make.
   4. The relation of liabilities to off-balance-sheet financing, taking a bath, and creating hidden reserves.

D. Auditors are concerned with ascertaining that liabilities are not materially understated. Materially understated liabilities could result in the auditor being sued.
E. Attempts by managers to minimize the amount reported as liabilities may lead to innovative financing arrangements resulting in off-balance-sheet financing.

III. Current liabilities.

A. Obligations expected to require the use of current assets or the creation of other current liabilities.

B. Since current liabilities are short-term, the time value of money is ignored and current liabilities are carried at face value.

C. Determinable current liabilities.

1. Liabilities that can be precisely measured; the amount of cash necessary to satisfy the obligation and the payment date are reasonably certain.

2. Classifications.

   a) Accounts payable.

      (1) The amounts owed to other entities for goods, supplies, and services purchased on open account.

      (2) Measurement issues are accounting for purchase cutoffs at the end of the accounting period and accounting for sales discounts.

   b) Short-term debts.

      (1) Short-term notes—usually carried at their face value less any discount. The discount represents interest on the note and is generally amortized (for short-term notes) using the straight-line method.

      (2) Current maturities of long-term debts—the portion of long-term debt that matures within the time frame of current assets (i.e., will be settled using current assets) should be reported as a current liability.

   c) Dividend payable—the liability for dividends arises on the date the board of directors declares the dividend (See Chapter 12).

   d) Unearned revenues.

   e) Third-party collections.

      (1) Sales taxes.

      (2) Payroll withholdings.
f) Accrued liabilities.

(1) Normal accrued liabilities.

(2) Conditional liabilities.

(a) Liabilities for which the amount of the obligation is conditional upon net income. Hence, the amount of the liability cannot be measured until the end of the accounting period.

(b) Income tax liability—the actual amount owed for local, state, and federal income taxes.

(c) Incentive compensation.

i) Incentive plans are one device that shareholders can use to try to align the manager's goals with their own goals.


D. Contingencies and contingent liabilities.

1. Contingencies are defined by the FASB as "an existing condition, situation, or set of circumstances involving uncertainty as to possible gain or loss to an enterprise that will ultimately be resolved when one or more future events occurs or fails to occur." That is, an event has taken place as of the balance sheet date that may or may not have an economic effect on the company, but the actual effect on the company will not be known until sometime in the future.

2. Accounting for contingencies.

a) Contingencies are governed by SFAS No. 5, "Accounting for Contingencies."

b) Gain contingencies.

(1) A contingency whose resolution could be financially advantageous to the company (i.e., result in an increase in assets or a decrease in liabilities).

(2) Gain contingencies are never accrued for in the financial statements. Under conservatism, gains are not recognized until the gain is realized. Gain contingencies may, if both reasonably estimable and probable, be disclosed in the footnotes.
c) Loss contingencies.

(1) A contingency whose resolution could be financially disadvantageous to the company (i.e., result in a decrease in assets or an increase in liabilities).

(2) General accounting treatment for loss contingencies.

(a) If an adverse resolution to the uncertainty is remote, then the contingency may be ignored for financial statement purposes.

(b) If an adverse resolution to the uncertainty is reasonably possible, then the contingency, and all relevant information, should be disclosed in a footnote.

(c) If an adverse resolution to the uncertainty is probable but the amount of the loss is not reasonably estimable, then the contingency, and all relevant information, should be disclosed in a footnote.

(d) If an adverse resolution to the uncertainty is probable and the amount of the loss is reasonably estimable, then a loss should be accrued in the financial statements.

3. Types of loss contingencies.

a) Lawsuits.

b) Environmental costs.

c) Warranties—the post-sale costs under the terms of the warranty should be estimated and then recognized as an expense and contingent liability in the period that the underlying sale took place.

IV. Provisions vs. contingent liabilities: The “devil is in the details”.

V. ROE exercise

VI. Retirement costs: pensions and postretirement health care and insurance (Appendix 10A).

A. Pensions.

1. Money paid to a retired or disabled employee, the amount of which is usually determined by the employee’s years of service.

2. Pension plans are usually administered by someone outside the company.
3. Types of pension plans.
   a) Defined contribution plan—the company promises to make periodic payments into the pension fund. The company only guarantees the contributions into the plan, not the benefits to be disbursed to employees.
   b) Defined benefit plan—the company guarantees a specified payout upon the employee's retirement.

4. In accordance with the matching principle, pension expenses should be recorded in the accounting period in which the employees earn the rights to the future benefits.

5. A company's pension liability represents the difference between the company's contribution to the plan to date and the estimated amount necessary to meet the guaranteed employee benefits.

B. Postretirement health care and insurance costs.

VII. Deferred income taxes (Appendix 10B).

A. An account to reconcile the difference between a company's income tax expense and income tax liability. This difference arises due to differences in measuring net income under GAAP and the Internal Revenue Code.
   1. Tax liability is based on the company's tax rate and the company's net income using the Internal Revenue Code.
   2. Income tax expense is based on the company's tax rate and the company's net income using GAAP.

B. Theoretically, the amount reported as deferred income taxes will eventually be paid as income taxes as the income differences between GAAP and the Internal Revenue Code reverse.
   1. Managers may make certain investing and/or operating decisions that effectively postpone the reversal period, thereby indefinitely postponing paying these taxes.
   2. Changes in the statutory tax rates result in restatement of the balance in the deferred income tax account, thereby giving rise to recognized gains or losses.

C. The conservatism ratio provides a quick way to assess how conservative management's reporting choices have been in a particular year. It measures the extent to which reported income before taxes differs from taxable income.

VIII. Review problem
IX. Ethics in the real world.

X. Internet research exercise.

**LECTURE TIPS**

1. The need for companies to be concerned with contingencies even though the company may not be affected should be discussed in the context of the objective of financial accounting (i.e., providing information to investors regarding a company's investment potential and credit worthiness). The diagram in figure 10–5 in the text is especially useful for an overview of accounting for contingencies. It should be emphasized that the event must first have occurred. It should also be pointed out that contingent losses can be booked as asset valuation accounts (e.g., allowance for bad debts) as well as liabilities. It is helpful to summarize typical types of loss contingencies into categories:

<table>
<thead>
<tr>
<th>Potential loss from:</th>
<th>Usually Accrued</th>
<th>Not Accrued</th>
<th>Maybe Accrued</th>
<th>*based on probable and estimable criteria</th>
</tr>
</thead>
<tbody>
<tr>
<td>Uncollectible receivables</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Product warranties</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Risk of loss from fire, flood, or other hazards</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>General business risks</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Environmental costs</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Lawsuits</td>
<td></td>
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</tr>
</tbody>
</table>

2. Students' views often vary widely on numerical values for the degrees of probability expressed in accounting for contingencies. An interesting class exercise is to poll the class as to their numerical assignment of probabilities to the "remote," "reasonably possible," and "probable" expressions. A study** examined the differences among key groups of audit opinion users and professional auditors concerning the meaning of the term "substantial doubt" used in the audit literature for the going concern issue. The study employed a survey in which subjects were asked to assign probability values to the term "substantial doubt," and also, especially of interest here, to "possible" and "probable." Significant differences were noted among participants concerning "substantial doubt," but not for the "possible" and "probable" expressions. The mean response for auditors was 0.4067 for "possible" and 0.7296 for "probable."

ANSWERS TO IN-TEXT DISCUSSION QUESTIONS

438. The FASB has established three criteria for recognition of an obligation as a liability: (1) it should be a present obligation that will be settled by probable future transfers of assets or provisions of services; (2) it should be an unavoidable obligation; and (3) the transaction or event obliging the enterprise must have already happened. In the case of an equipment lease, items (1) and (2) may have been met, but item (3) has not yet happened. A lease is an executory contract which is not completed except through future use. The lease obligation of FedEx of $1.8 billion is for the next year's use of the equipment. This treatment was appropriate if the lease was not in fact a capital lease, as covered in Chapter 11.

438. Companies like Kimberly-Clark and General Electric have substantial amounts of physical assets which warrant associated borrowings. General Electric also has a significant amount of financial assets which also support related borrowings; its balance sheet looks more like that of a financial institution than a manufacturer. Internet companies, on the other hand, do not have a significant physical or financial asset-base which would support borrowings. Also, their operations are inherently more risky. Accordingly, internet companies must rely more on equity capital than debt financing.

441. Motorola may have engaged in a strategy of “taking a bath”, reporting maximum liabilities, and thereby accelerating recognition of related expenses, in the earlier years in order to be able to report higher earnings in future years. The fact that in later years Motorola bounced back, reporting a large profit, and that none of the restructuring losses recognized in the earlier years required any cash payments, suggests that Motorola purposely “built hidden reserves.” Investors should be concerned because they are not being provided a true picture of the earning pattern of the company. Auditors usually more concerned with the possibility of understated liabilities, but must also be concerned with overstated liabilities, especially where they are part of a strategy of earnings management.

442. Because these short-term borrowings are intended to be refinanced, they are not expected to require the use of current assets and are therefore not disclosed as current.

442. The Bank of New York’s current liabilities consist primarily of deposit liabilities to customers which are its largest source of funding. AT&T, on the other hand, would have more in the way of long-term debt than current, to finance its vast infrastructure of long-term physical assets.

443. Airlines adopted programs of giving away free flights to frequent flyers as an incentive to build customer loyalty. The awards were expected to be accommodated with otherwise-empty seats. The incremental cost to the airlines of a free flight was minimal, so liabilities were not recorded or recorded at only a small amount. The frequent-flyer programs have become so successful, that in some cases free-flight awards have to be satisfied by using seats that otherwise would have generated revenue. The immateriality of incremental costs is a less persuasive argument than it once was. Airlines already have high liabilities, with associated debt covenants, and also experience fluctuating profitability, so they have a strong incentive to minimize recorded liabilities, or to postpone liabilities.
whenever possible. The accounting for these programs remains a controversial subject.

445. J.C. Penney is retailer in the business of selling merchandise. Its largest current asset would be inventory, which to the extent possible would be directly financed with accounts payable. Biomet is a manufacturer of medical products, for which the cost of products is not as key of a cost component as merchandise is to a retailer. Most likely Biomet’s highest costs are for research and development of new products, and marketing and administrative costs.

446. Accounts payable are amounts due to vendors for goods, supplies, and services purchased on open account. Accrued expenses are amounts due for expenses, such as wages and interest, incurred but not yet paid. Short-term loans and notes payable arise from cash loans and are generally payable to banks or other lending companies within a year. Current maturities of long-term debt are installments of long-term debt which are currently due. Each category is classified as a current liability because it will be paid in the time period that defines current assets, that is, one year or the operating cycle, whichever is longer.

447. The $13 billion in unearned revenues in Microsoft’s balance sheet indicates that Microsoft collects a significant amount of revenues in advance of performing the related services. These advance payments are usually a current liability because the services are to be performed within a year of the time the monies are collected. Microsoft has a legal obligation to perform these services under the terms of these pre-paid contracts between Microsoft and its customers.

447. “Air traffic liability” is an industry-specific name for unearned revenue. Airlines recognize revenue when transportation is provided rather than when a ticket is sold. The amount of passenger ticket sales not yet recognized as revenue is reflected as air traffic liability. “Frequent flyer” liability represents the expected cost of satisfying customer claims for free or reduced-cost service pursuant to “frequent flyer” programs. These amounts represent estimates which must be periodically evaluated. Accounts payable, by contrast, represent fixed and determinable amounts due to vendors for goods, supplies, and services provided to Continental.

450. The purpose of incentive compensation plans is to encourage managers and employees to act in a manner consistent with the objectives of the shareholders. Because these arrangements are designed to benefit of the shareholders, it is important for the shareholders to monitor these plans to assure they are consistent with shareholder interests.

450. Executive compensation and bonuses in particular, were controversial in light of the taxpayer-funded bailout of the banks and other financial services firms. Because of the bailouts, taxpayers were indirectly footing the bill for these compensation payments, which many alleged were made in no small part to the same culprits that ruined the economy with their excesses. Some commentators suggested that executive compensation practices created incentives for the bankers to take on too much risk causing the collapse of the banking and financial services sector of our economy and creating the deepest recession in
decades. High executive compensation is either necessary to attract the best
talent, or a waste of the shareholders’ money, or somewhere in between these
two extremes. The fact that high executive compensation is the norm suggests
that argument, at least for the time being, has largely been won by the
executives. Disclosures in the financial statements are necessary because
incentive compensation measures often give management reason to manipulate
the financial statements in order to increase their compensation. Financial
statement users need this information in order to evaluate the credibility of
management assertions contained in the financial statements.

452. Lilly appears to be the plaintiff in the patent litigation mentioned. As plaintiff, they
have a “gain” contingency because they might win. Gain contingencies are never
recognized in the financial statements. The statement about the material adverse
impact of an unfavorable outcome is not clear because it does not specify
whether these adverse results will impact future operating results, liquidity etc. or
the past operating results that are reflected in the current financial statements
containing the disclosure. If the disclosure refers to past operating results, it
would be because Lilly is also a defendant in this litigation. It is not uncommon
for there to be countersuits in patent litigation.

454. Bristol-Myers Squibb would have recorded the following entry to record the
liability:

\[
\begin{array}{ccc}
DR & CR \\
Product liability losses (+E, -SE) & 38,000,000 \\
Product liability claims payable (+L) & 38,000,000
\end{array}
\]

The accrual would have been justified because the expense was both highly
probable and was estimable. For the year 2008 the accrual would not have
required the use of cash, so the amount would not be a use of cash in arriving at
cash flow from operations. In a cash flow statement using the direct approach for
cash flow from operations, the amount would not be deducted; in a statement
using the indirect approach, the amount of the liability would be added back to
net income as a non-cash charge to arrive at cash flow from operations.

455. FMC’s policy is in accordance with generally accepted accounting principles.
When they believe that they need to record a liability on their financial statements
and the amount of the liability is uncertain, but within a range, they use the lowest
end of the range. This practice is likely to result in understatement of liabilities
and overstatement of net income. A more conservative approach would be to
report a liability in an amount that represents the mid-point of the range. FMC’s
policy is in accordance with FASB Interpretation No. 14, “Reasonable Estimation
of the Amount of a Loss”.

456. Estimated costs of warranties should be reflected as expenses in the period the
tires are sold. Goodrich Corporation took on the responsibility for future warranty
services at the time of the sale, and the associated estimated costs should be
matched with the revenue recognized at the time of sale. Warranties are
contingent liabilities which are almost always reflected as expenses on the
financial statements, because they are highly probable and are estimable.
Goodrich paid approximately $43.9 million for warranties in 2009 (beginning
balance of $139.2 million, plus warranty expense for the year of $52.3 million, minus the ending liability of $147.6 million).

466. General Electric’s conservatism ratio decreased by over 50% in 2008. This is a very conservative presentation, suggesting that GE is implementing the strategy of “taking a bath” in 2008. Management appears to be making their financial statements look worse than ever, presumably hoping to show a burst of improvement in the succeeding year. More conservative accounting methods are being used and more conservative estimates are being employed. Close study of the footnotes and analysis of the differences between revenues and expenditures as reported on the tax returns versus revenues and expenditures as reported on the financial statements would reveal the details of what the differences are between GAAP net income and taxable income.