**FINANCIAL ACCOUNTING II**

**CHAPTER FIVE**

**CURRENT LIABILITIES AND CONTINGENCIES**

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**WHAT IS A LIABILITY?**

The question, “What is a liability?” is not easy to answer. For example, is preferred stock a liability or an ownership claim? The first reaction is to say that preferred stock is in fact an ownership claim, and companies should report it as part of stockholders’ equity. In fact, preferred stock has many elements of debt as well.1 The issuer (and in some cases the holder) often has the right to call the stock within a specific period of time—making it similar to a repayment of principal. The dividend on the preferred stock is in many cases almost guaranteed (the cumulative provision) - making it look like interest. As a result, preferred stock is but one of many financial instruments that are difficult to classify.

To help resolve some of these controversies, the FASB, as part of its conceptual framework study, defined liabilities as “probable future sacrifices of economic benefits arising 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.” In other words, a liability has three essential characteristics:

1. It is a present obligation that entails settlement by probable future transfer or use of cash, goods, or services.
2. It is an unavoidable obligation.
3. The transaction or other event creating the obligation has already occurred.

Because liabilities involve future disbursements of assets or services, one of their most important features is the date on which they are payable. A company must satisfy currently maturing obligations in the ordinary course of business to continue operating. Liabilities with a more distant due date do not, as a rule, represent a claim on the company’s current resources. They are therefore in a slightly different category.

This feature gives rise to the basic division of liabilities into (1) current liabilities and (2) long-term debt.

**WHAT IS A CURRENT LIABILITY?**

Recall that current assets are cash or other assets that companies reasonably expect to convert into cash, sell, or consume in operations within a single operating cycle or within a year (if completing more than one cycle each year). Current liabilities are “obligations whose liquidation is reasonably expected to require use of existing resources properly classified as current assets, or the creation of other current liabilities.”This definition has gained wide acceptance because it recognizes operating cycles of varying lengths in different industries. This definition also considers the important relationship between current assets and current liabilities.

The **operating cycle** is the period of time elapsing between the acquisition of goods and services involved in the manufacturing process and the final cash realization resulting from sales and subsequent collections. Industries that manufacture products requiring an aging process, and certain capital-intensive industries, have an operating cycle of considerably more than one year. On the other hand, most retail and service establishments have several operating cycles within a year.

Here are some typical current liabilities:

1. Accounts payable.
2. Notes payable.
3. Current maturities of long-term debt.
4. Short-term obligations expected to be refinanced.
5. Dividends payable.
6. Customer advances and deposits.
7. Unearned revenues.
8. Sales taxes payable.
9. Income taxes payable.
10. Employee-related liabilities.

**Accounts Payable**

Accounts payable, or **trade accounts payable**, is balances owed to others for goods, supplies, or services purchased on open account. Accounts payable arise because of the time lag between the receipt of services or acquisition of title to assets and the payment for them. The terms of the sale (e.g., 2/10, n/30 or 1/10, E.O.M.) usually state this period of extended credit, commonly 30 to 60 days.

Most companies record liabilities for purchases of goods upon receipt of the goods. If title has passed to the purchaser before receipt of the goods, the company should record the transaction at the time of title passage. A company must pay special attention to transactions occurring near the end of one accounting period and at the beginning of the next. It needs to ascertain that the record of goods received (the inventory) agrees with the liability (accounts payable), and that it records both in the proper period.

Measuring the amount of an account payable poses no particular difficulty. The invoice received from the creditor specifies the due date and the exact outlay in money that is necessary to settle the account. The only calculation that may be necessary concerns the amount of cash discount. See Chapter 1 for illustrations of entries related to accounts payable and purchase discounts using the gross and net methods.

**Notes Payable**

**Notes payable** are written promises to pay a certain sum of money on a specified future date. They may arise from purchases, financing, or other transactions. Some industries require notes (often referred to as **trade notes payable**) as part of the sales/ purchases transaction in lieu of the normal extension of open account credit. Notes payable to banks or loan companies generally arise from cash loans. Companies classify notes as short-term or long-term, depending on the payment due date. Notes may also be interest-bearing or zero-interest-bearing.

**Interest-Bearing Note Issued**

Assume that Castle National Bank agrees to lend $100,000 on March 1, 2010, to Landscape Co. if Landscape signs a $100,000, 6 percent, four-month note. Landscape records the cash received on March 1 as follows:

 **March 1** Cash 100,000

 Notes Payable 100,000

 ***(To record issuance of 6%, 4-month note to Castle National Bank)***

If Landscape prepares financial statements semiannually, it makes the following adjusting entry to recognize interest expense and interest payable of $2,000 ($100,000 x 6% x 4/12) at June 30:

 **June 30** Interest Expense 2,000

 Interest Payable 2,000

***(To accrue interest for 4 months on Castle National Bank note)***

If Landscape prepares financial statements monthly, its adjusting entry at the end of each month is $500 ($100,000 x 6% x 1/12).

At maturity (July 1), Landscape must pay the face value of the note ($100,000) plus $2,000 interest ($100,000 x 6% x 4/12). Landscape records payment of the note and accrued interest as follows.

 **July 1** Notes Payable 100,000

 Interest Payable 2,000

 Cash 102,000

***(To record payment of Castle National Bank interest bearing note and accrued interest at maturity)***

**Zero-Interest-Bearing Note Issued**

A company may issue a zero-interest-bearing note instead of an interest-bearing note.

A zero-interest-bearing note does not explicitly state an interest rate on the face of the note. **Interest is still charged**, however. At maturity the borrower must pay back an amount greater than the cash received at the issuance date. In other words, the borrower receives in cash the present value of the note. The present value equals the face value of the note at maturity minus the interest or discount charged by the lender for the term of the note. In essence, the bank takes its fee “up front” rather than on the date the note matures.

To illustrate, assume that Landscape issues a $102,000, four-month, zero-interestbearing note to Castle National Bank. The present value of the note is $100,000. Landscape records this transaction as follows.

 **March 1** Cash 100,000

 Discount on Notes Payable 2,000

 Notes Payable 102,000

***(To record issuance of 4-month, zero-interest-bearing note to Castle National Bank)***

Landscape credits the Notes Payable account for the face value of the note, which is $2,000 more than the actual cash received. It debits the difference between the cash received and the face value of the note to Discount on Notes Payable. **Discount on**

**Notes Payable is a contra account to Notes Payable, and therefore is subtracted from Notes Payable on the balance sheet.**

The followingshows the balance sheet presentationon March 1.

 Current liabilities:

 Notes payable $102,000

 Less: Discount on notes payable 2,000 $100,000

The amount of the discount, $2,000 in this case, represents the cost of borrowing $100,000 for 4 months. Accordingly, Landscape charges the discount to interest expense over the life of the note. That is, the Discount on Notes Payable balance **represents** **interest expense chargeable to future periods**. Thus, Landscape should not debit Interest Expense for $2,000 at the time of obtaining the loan. We discuss additional accounting issues related to notes payable in Chapter 6.

**Current Maturities of Long-Term Debt**

Companiesreport as part of their current liabilities the portion of bonds, mortgage notes, and other long-term indebtedness that matures within the next fiscal year. They categorizes this amount as **current maturities of long-term debt**. But Companies exclude long-term debts maturing currently as current liabilities if they are to be:

1. Retired by assets accumulated for this purpose that properly have not been shown as current assets,
2. Refinanced, or retired from the proceeds of a new debt issue, or
3. Converted into capital stock.

In these situations, the use of current assets or the creation of other current liabilities does not occur. Therefore, classification as a current liability is inappropriate. A company should disclose the plan for liquidation of such a debt either parenthetically or by a note to the financial statements. When only a part of a long-term debt is to be paid within the next 12 months, as in the case of serial bonds that it retires through a series of annual installments, **the company reports the maturing portion of long-term** **debt as a current liability**, and the remaining portion as a long-term debt.

However, a company should classify as current any liability that is **due on demand** (callable by the creditor) or will be due on demand within a year (or operating cycle,if longer). Liabilities often become callable by the creditor when there is a violation ofthe debt agreement. For example, most debt agreements specify a given level of equityto debt be maintained, or specify that working capital be of a minimum amount.

If the company violates an agreement, it must classify the debt as current because it is a reasonable expectation that existing working capital will be used to satisfy the debt. Only if a company can show that it is **probable** that it will cure (satisfy) the violation within the grace period specified in the agreements can it classify the debt as noncurrent.

**Short-Term Obligations Expected to Be Refinanced**

Short-term obligations are debts scheduled to mature within one year after the date of a company’s balance sheet or within its operating cycle, whichever is longer. Some **short-term obligations** are **expected to be refinanced** on a long-term basis. These short-term obligations will not require the use of working capital during the next year (or operating cycle).

At one time, the accounting profession generally supported the exclusion of shortterm obligations from current liabilities if they were “expected to be refinanced.” But the profession provided no specific guidelines, so companies determined whether a short-term obligation was “expected to be refinanced” based solely on management’s **intent** to refinance on a long-term basis. Classification was not clear-cut. For example, a company might obtain a five-year bank loan but handle the actual financing with 90-day notes, which it must keep turning over (renewing). In this case, is the loan a long-term debt or a current liability? Another example was the **Penn Central Railroad** before it went bankrupt. The railroad was deep into short-term debt but classified it as long-term debt. Why? Because the railroad believed it had commitments from lenders to keep refinancing the short-term debt. When those commitments suddenly disappeared, it was “good-bye Pennsy.” As the Greek philosopher Epictetus once said, “Some things in this world are not and yet appear to be.”

**Refinancing Criteria**

To resolve these classification problems, the accounting profession has developed authoritative criteria for determining the circumstances under which short-term obligations may be properly excluded from current liabilities. A company is required to exclude a short-term obligation from current liabilities if **both** of the following conditions are met:

1. It must **intend to refinance** the obligation on a long-term basis.
2. It must **demonstrate an ability** to consummate the refinancing.

**Intention** to refinance on a long-term basis means that the company intends to refinance the short-term obligation so that it will not require the use of working capital during the ensuing fiscal year (or operating cycle, if longer).

The company demonstrates the **ability** to consummate the refinancing by:

1. **Actually refinancing** the short-term obligation by issuing a long-term obligation or equity securities after the date of the balance sheet but before it is issued; or
2. Entering into a **financing agreement** that clearly permits the company to refinance the debt on a long-term basis on terms that are readily determinable.

If an actual refinancing occurs, the portion of the short-term obligation to be excluded from current liabilities may not exceed the proceeds from the new obligation or equity securities used to retire the short-term obligation. For example, **Montavon** **Winery** had $3,000,000 of short-term debt. Subsequent to the balance sheet date, but before issuing the balance sheet, the company issued 100,000 shares of common stock, intending to use the proceeds to liquidate the short-term debt at its maturity. If Montavon’s net proceeds from the sale of the 100,000 shares total $2,000,000, it can exclude from current liabilities only $2,000,000 of the short-term debt.

An additional question is whether a company should exclude from current liabilities a short-term obligation if it is paid off after the balance sheet date and replaced by long-term debt before the balance sheet is issued. To illustrate, Marquardt Company pays off short-term debt of $40,000 on January 17, 2011, and issues long-term debt of $100,000 on February 3, 2011. Marquardt’s financial statements, dated December 31, 2010, are to be issued March 1, 2011.

Should Marquardt exclude the $40,000 short-term debt from current liabilities? No—here’s why: Repayment of the short-term obligation required the use of **existing** current assets **before** the company obtained funds through long-term financing. Therefore, Marquardt must include the short-term obligations in current liabilities at the balance sheet date (see graphical presentation below).



**Dividends Payable**

A **cash dividend payable** is an amount owed by a corporation to its stockholders as a result of board of directors’ authorization. At the date of declaration the corporation assumes a liability that places the stockholders in the position of creditors in the amount of dividends declared. Because companies always pay cash dividends within one year of declaration (generally within three months), they classify them as current liabilities.

On the other hand, companies do not recognize accumulated but undeclared dividends on cumulative preferred stock as a liability. Why? Because **preferred** **dividends in arrears** are not an obligation until the board of directors authorizes the payment. Nevertheless, companies should disclose the amount of cumulative dividends unpaid in a note, or show it parenthetically in the capital stock section.

Dividends payable in the form of additional shares of stock are not recognized as a liability. Such **stock dividends** do not require future outlays of assets or services. Companies generally report such undistributed stock dividends in the stockholders’ equity section because they represent retained earnings in the process of transfer to paid-in capital.

**Customer Advances and Deposits**

Current liabilities may include **returnable cash deposits** received from customers and employees. Companies may receive deposits from customers to guarantee performance of a contract or service or as guarantees to cover payment of expected future obligations.

For example, a company like **Alltel Corp.** often requires a deposit on equipment that customers use to connect to the Internet or to access its other services. Alltel also may receive deposits from customers as guarantees for possible damage to property.

Additionally, some companies require their employees to make deposits for the return of keys or other company property.

The classification of these items as current or noncurrent liabilities depends on the time between the date of the deposit and the termination of the relationship that required the deposit.

**Unearned Revenues**

A magazine publisher receives payment when a customer subscribes to its magazines. An airline company sells tickets for future flights. And software companies, issue coupons that allow customers to upgrade to the next version of their software. How do these companies account for **unearned revenues** that they receive before delivering goods or rendering services?

1. Upon receipt of the advance, debit Cash, and credit a current liability account identifying the source of the unearned revenue.
2. Upon earning the revenue, debit the unearned revenue account, and credit an earned revenue account.

To illustrate, assume that Allstate University sells 10,000 season football tickets at $50 each for its five-game home schedule. Allstate University records the sales of season tickets as follows:

 **August 6** Cash 500,000

 Unearned Football Ticket Revenue 500,000

***(To record sale of 10,000 season tickets)***

After each game, Allstate University makes the following entry.

 **September 7** Unearned Football Ticket Revenue 100,000

 Football Ticket Revenue 100,000

***(To record football ticket revenues earned)***

Unearned Football Ticket Revenue is, therefore, unearned revenue. Allstate University reports it as a current liability in the balance sheet. As revenue is earned, a transfer from unearned revenue to earned revenue occurs. Unearned revenue is material for some companies: In the airline industry, tickets sold for future flights represent almost 50 percent of total current liabilities.

The following illustration shows specific unearned and earned revenue accounts used in selected types of businesses.



The balance sheet should report obligations for any commitments that are redeemable in goods and services. The income statement should report revenues earned during the period.

**Sales Taxes Payable**

Retailers like **Wal-Mart**, **Circuit City**, and **GAP** must collect sales taxes from customers on transfers of tangible personal property and on certain services and then must remit these taxes to the proper governmental authority. GAP, for example, sets up a liability to provide for taxes collected from customers but not yet remitted to the tax authority.

The Sales Taxes Payable account should reflect the liability for sales taxes due various governments. The entry below illustrates use of the Sales Taxes Payable account on a sale of $3,000 assuming a 4 percent sales tax is in effect.

 Cash or Accounts Receivable 3,120

 Sales 3,000

 Sales Taxes Payable 120

**Income Taxes Payable**

Any federal or regional income tax varies in proportion to the amount of annual income.

Using the best information and advice available, a business must prepare an income tax return and compute the income tax payable resulting from the operations of the current period. Corporations should classify as a current liability the taxes payable on net income, as computed per the tax return. Unlike a corporation, proprietorships and partnerships are not taxable entities. Because the individual proprietor and the members of a partnership are subject to personal income taxes on their share of the business’s taxable income, income tax liabilities do not appear on the financial statements of proprietorships and partnerships.

Most corporations must make periodic tax payments throughout the year in an authorized bank depository or a Federal Reserve Bank. These payments are based upon estimates of the total annual tax liability. As the estimated total tax liability changes, the periodic contributions also change. If in a later year the taxing authority assesses an additional tax on the income of an earlier year, the company should credit Income

Taxes Payable and charge the related debit to current operations.

Differences between taxable income under the tax laws and accounting income

under generally accepted accounting principles sometimes occur. Because of these differences,

the amount of income tax payable to the government in any given year may

differ substantially from income tax expense as reported on the financial statements.

Chapter 19 is devoted solely to income tax matters and presents an extensive discussion

of this complex topic.

**Employee-Related Liabilities**

Companies also report as a current liability amounts owed to employees for salaries or wages at the end of an accounting period. In addition, they often also report as current liabilities the following items related to employee compensation.

**1.** Payroll deductions.

**2.** Compensated absences.

**3.** Bonuses.

**Payroll Deductions**

The most common types of payroll deductions are taxes, insurance premiums, employee savings, and union dues. **To the extent that a company has not remitted the** **amounts deducted to the proper authority at the end of the accounting period, it** **should recognize them as current liabilities.**

**Compensated Absences**

**Compensated absences** are paid absences from employment—such as vacation, illness, and holidays. Companies should accrue a liability for the cost of compensation for future absences if **all of the following conditions** exist.

1. The employer’s obligation relating to employees’ rights to receive compensation for future absences is attributable to employees’ services **already** **rendered**.
2. The obligation relates to the rights that **vest or accumulate**.
3. Payment of the compensation is **probable**.
4. The amount can be **reasonably estimated**.

The illustration follow shows an example of an accrual for compensated absences, in an excerpt from the balance sheet of **Clarcor Inc.**



If an employer meets conditions (a), (b), and (c) but does not accrue a liability because of a failure to meet condition (d), it should disclose that fact. The following presentation shows an example of such a disclosure, in a note from the financial statements of **Gotham Utility Company**.



The following considerations are relevant to the accounting for compensated absences.

**Vested rights** exist when an employer has an obligation to make payment to an employee even after terminating his or her employment. Thus, vested rights are not contingent on an employee’s future service. **Accumulated rights** are those that employees can carry forward to future periods if not used in the period in which earned. For example, assume that you earn four days of vacation pay as of December 31, the end of your employer’s fiscal year. Company policy is that you will be paid for this vacation time even if you terminate employment. In this situation, your four days of vacation pay are vested, and your employer must accrue the amount.

Now assume that your vacation days are not vested, but that you can carry the four days over into later periods. Although the rights are not vested, they are accumulated rights for which the employer must make an accrual. However, the amount of the accrual is adjusted to allow for estimated forfeitures due to turnover.

A modification of the general rules relates to the issue of **sick pay**. If sick pay benefits vest, a company must accrue them. If sick pay benefits accumulate but do not vest, a company may choose whether to accrue them. Why this distinction? Companies may administer compensation designated as sick pay in one of two ways. In some companies, employees receive sick pay only if illness causes their absence. Therefore, these companies may or may not accrue a liability because its payment depends on future employee illness. Other companies allow employees to accumulate unused sick pay and take compensated time off from work even when not ill. For this type of sick pay, a company must accrue a liability because the company will pay it, regardless of whether employees become ill. **Companies should recognize the expense and related liability for compensated absences in the year earned by employees.**

**Bonus Agreements**

Many companies give a **bonus** to certain or all employees in addition to their regular salaries or wages. Frequently the bonus amount depends on the company’s yearly profit.

A company may consider **bonus payments** **to employees** as additional wages and should include them as a deduction in determining the net income for the year.

To illustrate the entries for an employee bonus, assume that Palmer Inc. shows income for the year 2010 of $100,000. It will pay out bonuses of $10,700 in January 2011. Palmer makes an adjusting entry dated December 31, 2010, to record the bonuses as follows:

 Employees’ Bonus Expense 10,700

 Profit-Sharing Bonus Payable 10,700

In January 2011, when Palmer pays the bonus, it makes this journal entry:

 Profit-Sharing Bonus Payable 10,700

 Cash 10,700

Palmer should show the expense account in the income statement as an operating expense. **The liability, Profit-Sharing Bonus Payable, is usually payable within a** **short period of time. Companies should include it as a current liability in the balance** **sheet.** Similar to bonus agreements are contractual agreements for **conditional expenses**.

Examples would be agreements covering rents or royalty payments conditional on the amount of revenues earned or the quantity of product produced or extracted. Conditional expenses based on revenues or units produced are usually less difficult to compute than bonus arrangements.

For example, assume that a lease calls for a fixed rent payment of $500 per month and 1 percent of all sales over $300,000 per year. The company’s annual rent obligation would amount to $6,000 plus $0.01 of each dollar of revenue over $300,000. Or, a royalty agreement may give to a patent owner $1 for every ton of product resulting from the patented process, or give to a mineral rights owner $0.50 on every barrel of oil extracted. As the company produces or extracts each additional unit of product, it creates an additional obligation, usually a current liability.

**CONTINGENCIES**

Companies often are involved in situations where uncertainty exists about whether an obligation to transfer cash or other assets has arisen and/or the amount that will be required to settle the obligation. For example:

* **Merck** may be a defendant in a lawsuit, and any payment is contingent upon the outcome of a settlement or an administrative or court proceeding.
* **Ford Motor Co.** provides a warranty for a car it sells, and any payments are contingent on the number of cars that qualify for benefits under the warranty.
* **Briggs & Stratton** acts as a guarantor on a loan for another entity, and any payment is contingent on whether the other entity defaults.

Broadly, these situations are called contingencies. A **contingency** is “an existing condition, situation, or set of circumstances involving uncertainty as to possible gain **(gain contingency)** or loss **(loss contingency)** to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur.”

**GAIN CONTINGENCIES**

**Gain contingencies** are claims or rights to receive assets (or have a liability reduced) whose existence is uncertain but which may become valid eventually. The typical gain contingencies are:

**1.** Possible receipts of monies from gifts, donations, bonuses, and so on.

**2.** Possible refunds from the government in tax disputes.

**3.** Pending court cases with a probable favorable outcome.

**4.** Tax loss carryforwards.

Companies follow a conservative policy in this area. Except for tax loss carryforwards, they do not record gain contingencies. A company discloses gain contingencies in the notes only when a high probability exists for realizing them. As a result, it is unusual to find information about contingent gains in the financial statements and the accompanying notes. The following excerpt presents an example of a gain contingency disclosure.



**LOSS CONTINGENCIES**

**Loss contingencies** involve possible losses. A liability incurred as a result of a loss contingency is by definition a contingent liability. **Contingent liabilities** depend on the occurrence of one or more future events to confirm either the amount payable, the payee, the date payable, or its existence. That is, these factors depend on a contingency.

**Likelihood of Loss**

When a loss contingency exists, the likelihood that the future event or events will confirm the incurrence of a liability can range from probable to remote. The FASB uses the terms **probable**, **reasonably possible**, and **remote** to identify three areas within that range and assigns the following meanings.

* **Probable**. The future event or events are likely to occur.
* **Reasonably possible**. The chance of the future event or events occurring is more than remote but less than likely.
* **Remote**. The chance of the future event or events occurring is slight.

Companies should accrue an estimated loss from a loss contingency by a charge to expense and a liability recorded only if **both** of the following conditions are met.

1. Information available prior to the issuance of the financial statements indicates that it is **probable that a liability has been incurred** at the date of the financial statements.
2. The amount of the loss can be **reasonably estimated**.

To record a liability, a company does not need to know the exact payee nor the exact date payable. **What a company must know is whether it is probable that it incurred** **a liability.**

To meet the second criterion, a company needs to be able to reasonably determine an amount for the liability. To determine a reasonable estimate of the liability, a company may use its own experience, experience of other companies in the industry, engineering or research studies, legal advice, or educated guesses by qualified personnel.

The following illustration shows an accrual recorded for a loss contingency, from the annual report of **Quaker State Oil Refining Company**.



Use of the terms probable, reasonably possible, and remote to classify contingencies involves judgment and subjectivity. The following table lists examples of loss contingencies and the general accounting treatment accorded them.



Practicing accountants express concern over the diversity that now exists in the interpretation of “probable,” “reasonably possible,” and “remote.” Current practice relies heavily on the exact language used in responses received from lawyers (such language is necessarily biased and protective rather than predictive). As a result, accruals and disclosures of contingencies vary considerably in practice. Some of the more common loss contingencies are:

**1.** Litigation, claims, and assessments.

**2.** Guarantee and warranty costs.

**3.** Premiums and coupons.

**4.** Environmental liabilities.

As discussed in the opening story, companies do not record or report in the notes to the financial statements general risk contingencies inherent in business operations

(e.g., the possibility of war, strike, uninsurable catastrophes, or a business recession).

**Litigation, Claims, and Assessments**

Companies must consider the following factors, among others, in determining whether to record a liability with respect to **pending or threatened litigation** and actual or possible

**Claims** and **assessments**.

**1.** The **time period** in which the underlying cause of action occurred.

**2.** The **probability** of an unfavorable outcome.

**3.** The ability to make a **reasonable estimate** of the amount of loss.

To report a loss and a liability in the financial statements, **the cause for litigation must have occurred on or before the date of the financial statements**. It does notmatter that the company became aware of the existence or possibility of the lawsuitor claims after the date of the financial statements but before issuing them. To evaluatethe probability of an unfavorable outcome, a company considers the following:the nature of the litigation; the progress of the case; the opinion of legal counsel; itsown and others’ experience in similar cases; and any management response to thelawsuit.

Companies can seldom predict the outcome of pending litigation, however, with any assurance. And, even if evidence available at the balance sheet date does not favor the company, it is hardly reasonable to expect the company to publish in its financial statements a dollar estimate of the probable negative outcome. Such specific disclosures might weaken the company’s position in the dispute and encourage the plaintiff to intensify its efforts.

With respect to **unfiled suits** and **unasserted claims and assessments**, a company must determine (1) the degree of **probability** that a suit may be filed or a claim or assessment may be asserted, and (2) the **probability** of an unfavorable outcome.

**Guarantee and Warranty Costs**

A **warranty (product guarantee)** is a promise made by a seller to a buyer to make good on a deficiency of quantity, quality, or performance in a product. Manufacturers commonly use it as a sales promotion technique. Automakers, for instance, “hyped” their sales by extending their new-car warranty to seven years or 100,000 miles. For a specified period of time following the date of sale to the consumer, the manufacturer may promise to bear all or part of the cost of replacing defective parts, to perform any necessary repairs or servicing without charge, to refund the purchase price, or even to “double your money back.”

Warranties and guarantees entail future costs. These additional costs, sometimes called “after costs” or “post-sale costs,” frequently are significant. Although the future cost is indefinite as to amount, due date, and even customer, a liability is probable in most cases. Companies should recognize this liability in the accounts if they can reasonably estimate it. The estimated amount of the liability includes all the costs that the company will incur after sale and delivery and that are incident to the correction of defects or deficiencies required under the warranty provisions. Warranty costs are a classic example of a loss contingency. Companies use two basic methods of accounting for warranty costs: (1) the cash basis method and (2) the accrual method.

**Cash Basis**

Under the **cash-basis method**, companies expense warranty costs as incurred. In other words, a **seller or manufacturer charges warranty costs to the period in which it** **complies with the warranty**. The company does not record a liability for future costs arising from warranties, nor does it charge the period of sale. Companies frequently justify use of this method, the only one recognized for income tax purposes, on the basis of expediency when warranty costs are immaterial or when the warranty period is relatively short. A company must use the cash-basis method when it does not accrue a warranty liability in the year of sale either because:

1. it is not probable that a liability has been incurred, or
2. it cannot reasonably estimate the amount of the liability.

**Accrual Basis**

If it is probable that customers will make warranty claims and a company can reasonably estimate the costs involved, the company must use the accrual method.

Under the **accrual method**, companies charge warranty costs to operating expense **in the year of sale**. The accrual method is the generally accepted method. Companies should use it whenever the warranty is an integral and inseparable part of the sale and is viewed as a loss contingency. We refer to this approach as the **expense** **warranty approach**.

***Example of Expense Warranty Approach.*** To illustrate the expense warranty method, assume that Denson Machinery Company begins production on a new machine in July

2010, and sells 100 units at $5,000 each by its year-end, December 31, 2010. Each machine is under warranty for one year. Denson estimates based on past experience with a similar machine, that the warranty cost will average $200 per unit. Further, as a result of parts replacements and services rendered in compliance with machinery warranties, it incurs $4,000 in warranty costs in 2010 and $16,000 in 2011.

1. Sale of 100 machines at $5,000 each, July through December 2010:

 Cash or Accounts Receivable 500,000

 Sales 500,000

1. Recognition of warranty expense, July through December 2010:

 Warranty Expense 4,000

 Cash, Inventory, Accrued Payroll 4,000

 ***(Warranty costs incurred)***

 Warranty Expense 16,000

 Liability under Warranties 16,000

 ***(To accrue estimated warranty costs)***

The December 31, 2010, balance sheet reports “Estimated liability under warranties” as a current liability of $16,000, and the income statement for 2010 reports “Warranty expense” of $20,000.

1. Recognition of warranty costs incurred in 2011 (on 2010 machinery sales):

 Liability under Warranties 16,000

 Cash, Inventory, Accrued Payroll 16,000

 ***(Warranty costs incurred)***

If Denson Machinery applies the cash-basis method, it reports $4,000 as warranty expense in 2010 and $16,000 as warranty expense in 2011. It records all of the sale price as revenue in 2010. In many instances, application of the cash-basis method fails to match the warranty costs relating to the products sold during a given period with the revenues derived from such products. As such, **it violates the expense** **recognition principle**. Where ongoing warranty policies exist year after year, the differences between the cash and the expense warranty bases probably would not be so great.

***Sales Warranty Approach.*** A warranty is sometimes **sold separately from the product**.

For example, when you purchase a television set or DVD player, you are entitled to the manufacturer’s warranty. You also will undoubtedly be offered an extended warranty on the product at an additional cost.

In this case, the seller should recognize separately the sale of the television or DVD player, with the manufacturer’s warranty and the sale of the extended warranty.

This approach is referred to as the **sales warranty approach**. **Companies defer revenue on the sale of the extended warranty** and generally recognize it on a straight-line basisover the life of the contract. The seller of the warranty defers revenue because it hasan obligation to perform services over the life of the contract. The seller should onlydefer and amortize costs that vary with and are directly related to the sale of the contracts(mainly commissions). It expenses those costs, such as employees’ salaries, advertising,and general and administrative expenses, that it would have incurred even ifit did not sell a contract.

To illustrate, assume you purchase a new automobile from Hanlin Auto for $20,000. In addition to the regular warranty on the auto (the manufacturer will pay for all repairs for the first 36,000 miles or three years, whichever comes first), you purchase at a cost of $600 an extended warranty that protects you for an additional three years or 36,000 miles. Hanlin Auto records the sale of the automobile (with the regular warranty) and the sale of the extended warranty on January 2, 2010, as follows:

 Cash 20,600

 Sales 20,000

 Unearned Warranty Revenue 600

It recognizes revenue at the end of the fourth year (using straight-line amortization) as

follows.

 Unearned Warranty Revenue 200

 Warranty Revenue 200

Because the extended warranty contract only starts after the regular warranty expires, Hanlin Auto defers revenue recognition until the fourth year. If it incurs the costs of performing services under the extended warranty contract on other than a straight-line basis (as historical evidence might indicate), Hanlin Auto should recognize revenue over the contract period in proportion to the costs it expected to incur in performing services under the contract.

**Premiums and Coupons**

Numerous companies offer premiums (either on a limited or continuing basis) to customers in return for boxtops, certificates, coupons, labels, or wrappers. The **premium** may be silverware, dishes, a small appliance, a toy, or free transportation. Also, **printed** **coupons** that can be redeemed for a cash discount on items purchased are extremely popular. A more recent marketing innovation is the **cash rebate**, which the buyer can obtain by returning the store receipt, a rebate coupon, and Universal Product Code (UPC label) or “bar code” to the manufacturer.

Companies offer premiums, coupon offers, and rebates to stimulate sales. Thus companies should charge the **costs of premiums and coupons to expense** **in the period of the sale** that benefits from the plan. The period that benefits is not necessarily the period in which the company offered the premium. At the end of the accounting period many premium offers may be outstanding and must be redeemed when presented in subsequent periods. In order to reflect the existing current liability and to match costs with revenues, the company estimates the number of outstanding premium offers that customers will present for redemption. The company then charges the cost of premium offers to Premium Expense. It credits the outstanding obligations to an account titled Liability for Premiums or Premium Liability.

The following example illustrates the accounting treatment for a premium offer. Fluffy Cakemix Company offered its customers a large nonbreakable mixing bowl in exchange for 25 cents and 10 boxtops. The mixing bowl costs Fluffy Cakemix Company 75 cents, and the company estimates that customers will redeem 60 percent of the boxtops.

The premium offer began in June 2010 and resulted in the transactions journalized below. Fluffy Cakemix Company records purchase of 20,000 mixing bowls at 75 cents as follows.

 Inventory of Premium Mixing Bowls 15,000

 Cash 15,000

The entry to record sales of 300,000 boxes of cake mix at 80 cents would be:

 Cash 240,000

 Sales 240,000

Fluffy records the actual redemption of 60,000 boxtops, the receipt of 25 cents per 10 boxtops, and the delivery of the mixing bowls as follows.

 Cash [(60,000 / 10) x $0.25] 1,500

 Premium Expense 3,000

 Inventory of Premium Mixing Bowls 4,500

Computation: (60,000 \_ 10) \_ $0.75 \_ $4,500

Finally, Fluffy makes an end-of-period adjusting entry for estimated liability for outstanding premium offers (boxtops) as follows.

 Premium Expense 6,000

 Liability for Premiums 6,000

Computation:

 Total boxtops sold in 2010 300,000

 Total estimated redemptions (60%) 180,000

 Boxtops redeemed in 2010 60,000

 Estimated future redemptions 120,000

Cost of estimated claims outstanding

(120,000 / 10) x ($0.75 \_ $0.25) = $6,000

The December 31, 2010, balance sheet of Fluffy Cakemix Company reports an “Inventory of premium mixing bowls” of $10,500 as a current asset and “Liability for premiums” of $6,000 as a current liability. The 2010 income statement reports a $9,000 “Premium expense” among the selling expenses.

**Environmental Liabilities**

Estimates to clean up existing toxic waste sites total upward of $752 billion over a 30-year period. In addition, cost estimates of cleaning up our air and preventing future deterioration of the environment run even higher. Consider some average environmental costs per company for various industries: 

These costs are likely to only grow, considering “Superfund legislation.” This federal legislation provides the Environmental Protection Agency (EPA) with the power to clean up waste sites and charge the clean-up costs to parties the EPA deems responsible for contaminating the site. These potentially responsible parties can have a significant liability.

In many industries, the construction and operation of long-lived assets involves obligations for the retirement of those assets. When a mining company opens up a strip mine, it may also commit to restore the land once it completes mining. Similarly, when an oil company erects an offshore drilling platform, it may be legally obligated to dismantle and remove the platform at the end of its useful life.

**Accounting Recognition of Asset Retirement Obligations**

A company must recognize an **asset retirement obligation (ARO)** when it has an existing legal obligation associated with the retirement of a long-lived asset and when it can reasonably estimate the amount of the liability. Companies should record the ARO at fair value.

***Obligating Events.*** Examples of existing legal obligations, which require recognition of a liability include, but are not limited to:

• decommissioning nuclear facilities,

• dismantling, restoring, and reclamation of oil and gas properties,

• certain closure, reclamation, and removal costs of mining facilities,

• closure and post-closure costs of landfills.

In order to capture the benefits of these long-lived assets, **the company is generally legally obligated for the costs associated with retirement of the asset**, **whether the company hires another party to perform the retirement activities or performs the activities with its own workforce and equipment**. AROs give rise to various recognitionpatterns. For example, the obligation may arise at the outset of the asset’s use (e.g.,erection of an oil-rig), or it may build over time (e.g., a landfill that expands over time).

***Measurement.*** A company initially measures an ARO at fair value, which is defined as the amount that the company would pay in an active market to settle the ARO. While active markets do not exist for many AROs, companies should estimate fair value based on the best information available. Such information could include market prices of similar liabilities, if available. Alternatively, companies may use present value techniques to estimate fair value.

***Recognition and Allocation.*** To record an ARO in the financial statements, a company includes the cost associated with the ARO in the carrying amount of the related long-lived asset, and records a liability for the same amount. It records an asset retirement cost as part of the related asset because these costs are tied to operating the asset and are necessary to prepare the asset for its intended use. Therefore, the specific asset (e.g., mine, drilling platform, nuclear power plant) should be increased because the future economic benefit comes from the use of this productive asset.

**Companies should not record the capitalized asset retirement costs in a separate account because there is no future economic benefit that can be associated with these costs alone.**

In subsequent periods, companies allocate the cost of the ARO to expense over the period of the related asset’s useful life. Companies may use the straight-line method for this allocation, as well as other systematic and rational allocations.

***Example of ARO Accounting Provisions.*** To illustrate the accounting for AROs, assume that on January 1, 2010, Wildcat Oil Company erected an oil platform in the Gulf of

Mexico. Wildcat is legally required to dismantle and remove the platform at the end of its useful life, estimated to be five years. Wildcat estimates that dismantling and removal will cost $1,000,000. Based on a 10 percent discount rate, the fair value of the asset retirement obligation is estimated to be $620,920 ($1,000,000 \_ .62092). Wildcat records this ARO as follows.

**January 1, 2010** Drilling Platform 620,920

 Asset Retirement Obligation 620,920

During the life of the asset, Wildcat allocates the asset retirement cost to expense.

Using the straight-line method, Wildcat makes the following entries to record this expense.

**December 31, 2010, 2011, 2012, 2013, 2014**

 Depreciation Expense ($620,920 / 5) 124,184

 Accumulated Depreciation 124,184

In addition, Wildcat must accrue interest expense each period. Wildcat records interest expense and the related increase in the asset retirement obligation on December 31, 2010, as follows.

**December 31, 2010**

 Interest Expense ($620,920 x 10%) 62,092

 Asset Retirement Obligation 62,092

On January 10, 2015, Wildcat contracts with Rig Reclaimers, Inc. to dismantle the platform at a contract price of $995,000. Wildcat makes the following journal entry to record settlement of the ARO.

**January 10, 2015**

 Asset Retirement Obligation 1,000,000

 Gain on Settlement of ARO 5,000

 Cash 995,000

Companies need to provide more extensive disclosure regarding environmental liabilities. In addition, companies should record more of these liabilities. The SEC believes that companies should not delay recognition of a liability due to significant uncertainty. The SEC argues that if the liability is within a range, and no amount within the range is the best estimate, then management should recognize the minimum amount of the range. That treatment is in accordance with GAAP*.* The SEC also believes that companies should report environmental liabilities in the balance sheet independent of recoveries from third parties. Thus, companies may not net possible insurance recoveries against liabilities but must show them separately. Because there is much litigation regarding recovery of insurance proceeds, these “assets” appear to be gain contingencies. Therefore, companies should not report these on the balance sheet.

**Self-Insurance**

As discussed earlier, contingencies are not recorded for general risks (e.g., losses that might arise due to poor expected economic conditions). Similarly, companies do not record contingencies for more specific future risks such as allowances for repairs. The reason: These items do meet the definition of a liability because they do not arise from a past transaction but instead relate to future events.

Some companies take out insurance policies against the potential losses from fire, flood, storm, and accident. Other companies do not. The reasons: Some risks are not insurable, the insurance rates are prohibitive (e.g., earthquakes and riots), or they make a business decision to self-insure. Self-insurance is another item that is not recognized as a contingency.

Despite its name, **self-insurance** is **not insurance**, **but risk assumption**. Any company that assumes its own risks puts itself in the position of incurring expenses or losses as they occur. There is little theoretical justification for the establishment of a liability based on a hypothetical charge to insurance expense. This is “as if” accounting.

The conditions for accrual stated in GAAP are not satisfied prior to the occurrence of the event. Until that time there is no diminution in the value of the property. And unlike an insurance company, which has contractual obligations to reimburse policyholders for losses, a company can have no such obligation to itself and, hence, no liability either before or after the occurrence of damage. The note in the following illustration from the annual report of **Adolph Coors** **Company** is typical of the self-insurance disclosure.



Exposure to **risks of loss resulting from uninsured past injury to others**, however, is an existing condition involving uncertainty about the amount and timing of losses that may develop. In such a case, a contingency exists. A company with a fleet of vehicles for example, would have to accrue uninsured losses resulting from injury to others or damage to the property of others that took place prior to the date of the financial statements (if the experience of the company or other information enables it to make a reasonable estimate of the liability). However, it should not establish a liability for **expected future injury** to others or damage to the property of others, even if it can reasonably estimate the amount of losses.**SECTION 3 • PRESENTATION AND ANALYSIS**

**PRESENTATION OF CURRENT LIABILITIES**

**In practice, current liabilities are usually recorded and reported in financial statements at their full maturity value.** Because of the short time periods involved,frequently less than one year, the difference between the present value of a currentliability and the maturity value is usually not large. The profession acceptsas immaterial any slight overstatement of liabilities that results from carryingcurrent liabilities at maturity value.

The current liabilities accounts are commonly presented as the first classification in the liabilities and stockholders’ equity section of the balance sheet. Within the current liabilities section, companies may list the accounts in order of maturity, in descending order of amount, or in order of liquidation preference. The following illustration presents an excerpt of Best Buy Company’s financial statements that is representative of the reports of large corporations.

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Detail and supplemental information concerning current liabilities should be sufficient to meet the requirement of full disclosure. Companies should clearly identify secured liabilities, as well as indicate the related assets pledged as collateral. If the due date of any liability can be extended, a company should disclose the details.

Companies should not offset current liabilities against assets that it will apply to their liquidation. Finally, current maturities of long-term debt are classified as current liabilities.

**A major exception exists when a company will pay a currently maturing obligation from assets classified as long-term.** For example, if a company will retire a bondpayable using a bond sinking fund that is classified as a long-term asset, it shouldreport the bonds payable in the long-term liabilities section. Presentation of this debtin the current liabilities section would distort the working capital position of theenterprise.

If a company excludes a short-term obligation from current liabilities because of refinancing, it should include the following in the note to the financial statements:

1. A general description of the financing agreement.
2. The terms of any new obligation incurred or to be incurred.
3. The terms of any equity security issued or to be issued.

When a company expects to refinance on a long-term basis by issuing equity securities, it is not appropriate to include the short-term obligation in stockholders’ equity. At the date of the balance sheet, the obligation is a liability and not stockholders’ equity.

Illustration below shows the disclosure requirements for an actual refinancing situation.



**PRESENTATION OF CONTINGENCIES**

A company records a loss contingency and a liability if the loss is both probable and estimable. But, if the loss is **either probable or estimable but not both**, and if there is at least a **reasonable possibility** that a company may have incurred a liability, it must disclose the following in the notes.

1. The nature of the contingency.
2. An estimate of the possible loss or range of loss or a statement that an estimate cannot be made.

Illustration below presents an extensive litigation disclosure note from the financial statements of **Raymark Corporation**. The note indicates that Raymark charged actual losses to operations and that a further liability may exist, but that the company cannot currently estimate this liability.



Companies should disclose certain other contingent liabilities, even though the possibility of loss may be remote, as follows.

1. Guarantees of indebtedness of others.
2. Obligations of commercial banks under “stand-by letters of credit.”
3. Guarantees to repurchase receivables (or any related property) that have been sold or assigned.

Disclosure should include the nature and amount of the guarantee and, if estimable, the amount that the company can recover from outside parties.**Cities Service Company** disclosed its guarantees of others’ indebtedness in the following note.



**ANALYSIS OF CURRENT LIABILITIES**

The distinction between current liabilities and long-term debt is important. It provides information about the liquidity of the company. Liquidity regarding a liability is the expected time to elapse before its payment. In other words, a liability soon to be paid is a current liability. Aliquid company is better able to withstand a financial downturn. Also, it has a better chance of taking advantage of investment opportunities that develop.

Analysts use certain basic ratios such as net cash flow provided by operating activities to current liabilities, and the turnover ratios for receivables and inventory, to assess liquidity. Two other ratios used to examine liquidity are the current ratio and the acid-test ratio.

**Current Ratio**

The **current ratio** is the ratio of total current assets to total current liabilities. The follow shows its formula. Current Ratio = Current Asset

 Current Liability

The ratio is frequently expressed as coverage of so many times. Sometimes it is called the **working capital ratio** because working capital is the excess of current assets over current liabilities. A satisfactory current ratio does not disclose that a portion of the current assets may be tied up in slow-moving inventories. With inventories, especially raw materials and work in process, there is a question of how long it will take to transform them into the finished product and what ultimately will be realized in the sale of the merchandise.

Eliminating the inventories, along with any prepaid expenses, from the amount of current assets might provide better information for short-term creditors. Therefore, some analysts use the acid-test ratio in place of the current ratio.

**Acid-Test Ratio**

Many analysts favor an **acid-test** or **quick ratio** that relates total current liabilities to cash, marketable securities, and receivables. The following shows the formula for this ratio. As you can see, the acid-test ratio does not include inventories.



To illustrate the computation of these two ratios, we use the information for **Best Buy Co.** above. Below is the computationof the current and acid-test ratios for Best Buy.



From this information, it appears that Best Buy’s current position is adequate. However, the acid-test ratio is well below 1. A comparison to another retailer, **Circuit City**, whose current ratio is 1.68 and whose acid-test ratio is 0.65, indicates that Best Buy is carrying fewer inventories than its industry counterparts.