Current Liabilities

Liabilities are considered to be "current" if they are expected to be "settled" within the next accounting period.

- Accounts Payable
- Short-term Notes Payable
- Commercial Paper
- Accrued Liabilities
- Advance Collections
  - Includes advance payments and refundable deposits

- Current Maturities of Long-Term Debt
- Obligations Callable by Creditor
- Short-Term Obligations Expected to be Refinanced

- Contingencies
- Warranties

Example: Honeywell

NOTE 14

ACCRUED LIABILITIES

December 31	1999	1998
Compensation and benefit costs	$ 828	$ 849
Customer advances	511	466
Income taxes	186	384
Environmental costs	104	128
Other	1,905	1,610
	$ 3,534	$ 3,437

Example: Ingersoll Rand

NOTE 7 - ACCOUNTS PAYABLE AND ACCRUALS: Accounts payable and accruals at December 31, were:

In millions	1999	1998
Accounts payable	$ 319.2	$ 371.5
Accrued:		
Payrolls and benefits	215.1	235.1
Taxes other than income	36.9	39.9
Insurance and claims	116.1	106.6
Postemployment benefits	82.3	63.3
Warranties	57.8	67.5
Interest	60.6	48.1
Other accruals	336.4	352.4
	$1,224.4	$1,284.4

Short-Term vs. Long-Term

- Why is this distinction important?
- Is it difficult to make this distinction?
- Would a company prefer that an obligation be listed as short-term or long-term?

Sometimes this distinction becomes less clear.

Note that the current maturity of Long-Term debt should be listed as short-term. This includes installment notes, leases, bonds, etc.

Obligations Callable by Creditor

- If the creditor has the right to "call" a long-term debt obligation within the next year, the obligation is listed as a current liability, even if it has a non-current maturity.

- This usually arises when a company violates a debt covenant.

  - A debt covenant states that the borrower will maintain certain financial conditions or will not undertake certain activities.
    - Maintain a given current ratio, working capital amount, cash amount, etc.
    - Restrictions on new senior borrowings, capital spending, dividend payments.
  - If a company violates a debt covenant, the lender has the right to demand immediate repayment.

- In order to avoid classifying the debt as current, the borrower must obtain a waiver from the lender.

Short-Term Obligations Expected to be Refinanced

Consider a company that has a loan that is due next year. Normally the loan will be listed as a current liability. However, what if the company intends to take out a new loan and use the proceeds from the new loan to pay-off the old loan? Then the company can reasonably argue that it did not use its own funds to pay off the loan and that the obligation should be listed as noncurrent.

Short-term obligations can be listed as noncurrent if:

- The borrower intends to refinance on a long-term basis.
- The borrower can demonstrate the ability to do so.

Assume that you are an auditor and your client argues that a current liability should be listed as long-term because of their intent to refinance on a long-term basis. What evidence would you require?

The following excerpt was taken from Note 6 in IMO Industries 1992 Annual Report.

Primarily as a result of the unusual items incurred in the third quarter of 1992 and the adoption of the new accounting standard for postretirement benefits, the Company is not in compliance with certain financial covenants under its revolving credit agreement and its senior notes as of December 31, 1992. Since waivers of these covenants have not been obtained, $77 million of long-term debt has been classified as current.

The Company is currently negotiating with banks party to the revolving credit agreement, other domestic banks and the holder of its senior notes in an effort to finalize a satisfactory restructuring of this debt. The Company and its investment bankers believe that a final agreement will be reached in the near future.

The following excerpt was taken from the audit report signed by Ernst & Young.

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The accompanying consolidated financial
statements have been prepared assuming that
Imo Industries Inc. will continue as a going
concern.  As more fully described in Note 6,
the Company is not in compliance with its
senior debt agreements, and to date, has not
arranged a long-term refinancing of the
senior debt obligations.  This condition
raises substantial doubt about the Company's
ability to continue as a going concern.  The
1992 consolidated financial statements do
not include any adjustments that might
result from the outcome of this uncertainty.
```

Note that the opinion was dated February 18, 1993, except for Note 6, as to which the date is April 14, 1993.

Contingent Liabilities

A contingent liability occurs when a company enters into a transaction that could lead to a payment in the future. However, the amount of the payment (or whether a payment will ever occur) is dependent upon some future event.

Any material contingent liabilities (such as lawsuits) must be disclosed. The question is whether an amount should be recorded in the financial statements.

According to GAAP, a liability is recorded if payment is **probable** and the amount of the payment can be **reasonably estimated**.

Example: R J Reynolds 1997 Annual Report

Litigation is subject to many uncertainties, and it is possible that some of the tobacco-related legal actions, proceedings or claims could be decided against RJRT or its affiliates (including RJRN Holdings and RJRN) or indemnitees. Determinations of liability or adverse rulings against other cigarette manufacturers that are defendants in similar actions, even if such rulings are not final, could adversely affect the litigation against RJRT or its affiliates or indemnitees and could encourage an increase in the number of such claims. There have also been a number of political, legislative, regulatory and other developments relating to the tobacco industry and cigarette smoking that have received wide media attention. Although it is impossible to predict the outcome of such events on pending litigation and the rate at which new lawsuits are filed against RJRT and RJRN, a significant increase in litigation activities could have an adverse effect on RJRT. RJRT believes that it has a number of valid defenses to any such actions, including but not limited to those defenses based on preemption under the Cipollone decision, and RJRT intends to defend all such actions vigorously. RJRN Holdings and RJRN also believe they have valid defenses for such actions and intend to defend vigorously all such actions in which they are named defendants.

RJRN Holdings and RJRN believe that the ultimate outcome of all pending litigation matters (including litigation costs) should not have a material adverse effect on the financial position of either RJRN Holdings or RJRN; however, it is possible that the results of operations or cash flows of RJRN Holdings or RJRN in particular quarterly or annual periods or the financial condition of RJRN Holdings and RJRN could be materially affected by the ultimate outcome of certain pending litigation matters (including litigation costs). Management is unable to derive a meaningful estimate of the amount or range of any possible loss in any particular quarterly or annual period or in the aggregate.

R J Reynolds 1998

NOTE 3--OPERATIONS

TOBACCO SETTLEMENT AND RELATED EXPENSES

RJRT recorded pre-tax charges totaling $1.442 billion during 1998 for tobacco settlement and related expenses as follows:

Multi-state settlement agreement	$	620
Minnesota settlement agreement		312
"Most favored nation" adjustments for previously settled states		145
Rationalization of manufacturing operations		214
Employee severance and related benefits		151
	$	1,442

For a discussion regarding the provisions of the multi-state settlement, the Minnesota settlement and the most favored nation adjustments see note 10. The rationalization of manufacturing operations primarily represents a charge to write-down the book value of RJRT's production facility and certain equipment in Winston-Salem, North Carolina to fair value. The employee severance and related benefits expense represents a charge for workforce reductions totaling approximately 1,300 employees. These charges were in response to the changing business conditions which could result from the multi-state settlement agreement signed in November 1998. RJRT anticipates that the November price increase, which was necessary to satisfy its ongoing annual payment obligations under the multi-state settlement agreement, is likely to adversely affect volume and its results of operations.

Cash expenditures related to the termination of employees is anticipated to be approximately $100 million and will be paid from operations into the year 2000. As of December 31, 1998, $268 million of the accrual was utilized as follows: $54 million for severance and related benefits and $214 million for rationalization of manufacturing operations.

RJRT recorded pre-tax charges totaling $359 million during 1997 related to settlement agreements reached with the Florida, Mississippi and Texas state attorneys general and in certain class action cases. See note 10 for further discussion.

NOTE 7--ACCRUED LIABILITIES

	1998	1997
Payroll and employee benefits	$ 564	$ 595
Marketing and advertising	535	424
Excise taxes	220	205
Restructuring	388	368
Dividends	183	186
Tobacco settlement and related accruals	610	177
Accrued interest	192	163
Other	654	632
	$ 3,346	$ 2,750

Warranties

If the customer pays an additional amount for an extended warranty, the amount received is considered to be deferred revenue to be recognized over the life of the warranty.

If it is a manufacturer original warranty, the seller should estimate the future cost of warranty claims.

Example: ABC Corp generally expects 5% of its units to require warranty repair at an average cost of $18 per unit. During 2000, ABC sells 100,000 units and repairs 8,000 units at a total cost of $150,000. At 1/1/00, the balance in the accrued warranty account is $115,000.

The warranty entries would be:

Dr. Warranty expense	$90,000	
Cr. Accrued warranty cost		$90,000
Dr. Accrued warranty cost	$150,000	
Cr. Cash		$150,000

The ending balance in the accrued warranty account is:

Beginning	$115,000
2000 Accrual	90,000
2000 Payments	(150,000)
Ending	$55,000

It is important to recognize that the ending balance in the account, $55,000 has a meaning. Specifically, that should be the expected future cost of existing warranties.

Suppose that as of 12/31/00, 80,000 units were still covered by warranties and that the average expected future repair cost was $23 per unit.

Then the ending balance in the account should be:
80,000 x 5% x $23 = $92,000

Because the balance in the account is only $55,000 an additional adjusting entry is required:

Dr. Warranty expense $37,000
    Cr. Accrued warranty cost $37,000

The total warranty cost for 2000 is then:
$90,000 + $37,000 = $127,000

Suggested Review Problems

E13-7, E13-9, E13-10, P13-6