

Current and Contingent Liabilities

Pratt, Financial Accounting 7e, Chapter 10

Liability:

- Probable future sacrifices of economic benefits arising from present obligations or a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events
- All recognized liabilities:
 - Are present obligations that entail settlements by probable future transfers or uses of cash, goods, or services
 - Are unavoidable obligations
 - The transaction or event that gives rise to the obligation has already occurred

Current Liabilities:

- Obligations that are expected to require the use of current assets or the creation of other current liabilities
- Note is a liability is due within one year, or the operating cycle whichever is longer, it should be treated as current unless:
 - Assets not classified as current will be used to settle the liability or
 - The liability will be settle by refinanced by issuing either long-term debt or equity or
 - Can be refinanced continuously with other current liabilities

Types of Current Liabilities:

- Determinable current liabilities:
 - Accounts Payable
 - Short-term debts
 - Short-term notes
 - Current maturities of long-term debts
 - Dividends Payable
 - Unearned Revenues
 - Third-Party Collections
 - Income Taxes
 - Incentive Compensation
- Contingent Liabilities
 - Lawsuits
 - Warranties

Contingencies

	Losses	Gains
Remote	No disclosure or accrual required	No disclosure or accrual required
Reasonably Possible	Disclosure required	No disclosure or accrual required
Probable	Disclosure required, if amount of loss can be estimated then accrual required	Disclosure required, accrual is never appropriate until realized

Lawsuits – a common cause of contingent liabilities.

Example (1 of 5 included in Seagate Technologies most recent annual report) on the next page.

Shao Tong, et al. v. Seagate International (Wuxi) Co., Ltd. In July 2002, we were sued in the People's Court of Nanjing City, China, by an individual, Shao Tong, and a private Chinese company, Nanjing Yisike Network Safety Technique Co., Ltd. The complaint alleged that two of our personal storage disc drive products infringe Chinese patent number ZL94111461.9, which prevents the corruption of systems data stored on disc drives. The suit, which sought to stop us from manufacturing the two products and claimed immaterial monetary damages, was dismissed by the court on procedural grounds on November 29, 2002. On December 3, 2002, the plaintiffs served us with notice that they had refiled the lawsuit. The new complaint contains identical infringement claims against the same disc drive products, claims immaterial monetary damages and attorney's fees and requests injunctive relief and a recall of the products from the Chinese market. Manufacture of the accused products ceased in May 2003. At a hearing on March 10, 2003, the court referred the matter to an independent technical advisory board for a report on the application of the patent claims to the two products. On June 10, 2003, we presented our non-infringement case to the technical panel. The panel issued a technical advisory report to the court finding no infringement. The court heard oral arguments on the technical advisory report in September 2003, issued an order that our products do not infringe the patent and rejected plaintiffs' lawsuit. Plaintiffs filed an appeal with the Jiangsu High Court, and we filed our opposition brief on January 21, 2004. The PRC Patent Reexamination Board declared patent ZL94111461.9 invalid on March 28, 2004. The Jiangsu High Court stayed the appeal on the infringement case pending a final judgment on patent invalidity. On June 22, 2004, Shao Tong filed a lawsuit in the Beijing Intermediate People's Court against the PRC PRB challenging its patent invalidity decision. On November 29, 2004, the court affirmed the decision of patent invalidity. In December 2004, Shao Tong appealed the decision to the Beijing High People's court, the highest appellate court. On November 29, 2004, the court affirmed the decision of patent invalidity. In December 2004, Shao Tong appealed the decision to the Beijing High People's Court, the highest appellate court, and a hearing was held June 22, 2005. The court scheduled a rehearing on December 8, 2005, and subsequently reversed the lower court and PRB decisions due to a procedural error. The case was remanded to the PRB for further action to correct the procedural error. A new PRB panel was appointed and the procedural error was corrected and the invalidity case reargued at a hearing on May 9, 2006. In 2006, we filed a second invalidity proceeding with the PRB. On June 14, 2007, the PRB issued an order holding the patent invalid based on the first invalidity request. The second invalidity request was stayed as a result of the ruling on the first request. We believe the claims are without merit, and we intend to defend against them vigorously.

Warranties

Warranties are offered as an inducement to sell. Therefore the cost of warranties should be matched against the revenue produced in the period of sale. However in many cases the cost of the warranty represents a contingent liability, so it must be estimated.

Example: During 2007 Smith Corp. sells 10,000 units of a product for \$200 each. Included with each product sold is a warranty that requires Smith Corp. to repair or replace any defective item for a period of two years from the date of sale. Based on past experience Smith Corp. estimates that 10% of the units sold will require warranty work at an average cost of \$50 per unit. During 2007 400 units were repaired or replaced at a total cost of \$36,000.

Cash (or Accts. Rec.)	2,000,000	
Sales (10,000 x \$200)		2,000,000
Warranty Expense	50,000	
Estimated Liability under Warranties (10,000 X .1 X \$50)		50,000
Estimated Liability under Warranties	36,000	
Cash, Inventory, etc.		36,000

Pensions – See Appendix 10A

Defined Benefit vs. Defined Contribution Plans

Deferred Taxes – See Appendix 10B

Companies use different rules in computing their book income and their taxable income. Example – Depreciation using Straight Line method vs. MACRS.

When timing differences arise a company will record deferred tax assets and liabilities.