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ACCOUNTING FOR CONTINGENCIES: EXPLORING ACCOUNTING CHOICE, SUBJECTIVITY, AND REPORTING ISSUES

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ABSTRACT

Assessing contingency reserves is often a difficult concept for students to grasp because of their lack of real world experience. This realistic case gives students an opportunity to develop critical thinking skills through the evaluation of accounting estimates and through the consideration of the subjective nature of estimates and other environmental influences that impact accounting choice. Students are presented with a rich context in which they are required to interpret and apply GAAP in a situation where there is no objectively correct answer. In addition, the case introduces situations that accounting professionals encounter in practice, such as dealing with client and auditor disagreements, and auditors' and client management's responsibilities under the Sarbanes-Oxley Act. Topics covered in the case include: accounting estimates, loss contingencies, earnings management, audit committees and the auditing and financial reporting environment. This case is appropriate for use in an intermediate accounting course, an auditing course, a capstone course, or a graduate level accounting theory course.

INTRODUCTION

You work as an audit manager for a Big Four accounting firm. Your firm is located in a large metropolitan market where all of the Big Four international accounting firms as well as the large national accounting firms have a presence, resulting in intense competition for clients. The local office of your firm has a large, diversified client base consisting mainly of Fortune 500 companies. For the past two years, your firm has been engaged to perform the financial statement audit of Digicom Manufacturing Corporation. Digicom is a large audit client for your local office in terms of both engagement hours and engagement profitability.

This year, you have been assigned to the Digicom audit for the first time. Digicom is currently your largest audit client in terms of engagement billings and billable hours. Aside from the engagement partner, you are the highest-ranking member of the audit team.

CLIENT BACKGROUND

Digicom Manufacturing Corporation ("the client") is a manufacturer of computer equipment. Digicom is a Fortune 500 public company, based in the United States; its stock is actively traded on the New York Stock Exchange. Over the past several years Digicom has had consistent sales and pretax income growth in the range of 5 - 10% per year. Strong management, a healthy economy, and a consistent record of product innovations are the key factors that have fueled this growth. This year, however, new products coming to market have not met sales expectations, and sales growth has slowed significantly to less than 1% over the prior year.

The CEO, Chris Mitchell, is responsible for all of the company's day-to-day operations, but focuses his time and attention primarily on new product and design issues. Mitchell is an engineer by training and rose through the ranks at Digicom in the manufacturing division of the company. He takes pride in his record of providing shareholder value; EPS and stock price have risen steadily under his tenure as CEO. Mitchell is not an expert in accounting and financial reporting issues; his primary financial reporting concern is the "bottom line." He relies on the CFO, Julie Farrell, for technical accounting guidance. Farrell has been with the company for many years and has a good grasp on the operations as well as the accounting issues of the business. She is well respected within the company; however, she is known to be headstrong and inflexible at times.

There has been low turnover of top management at Digicom; key employees are well compensated and receive a significant portion of their incomes through stock option and bonus programs. The accounting staff is professional and well trained. They are dedicated and work long hours to provide management with the financial analyses used to manage the business.

Digicom has an audit committee that is comprised of outside directors. The audit committee meets with the internal and external auditors several times each year to discuss the effectiveness of internal controls, the scope of the independent audit, the results of operations, and the results of the independent audit. Prior year work papers do not indicate any major problems regarding internal controls or client integrity.

CURRENT YEAR

At this time, the audit for the year ended December 31, 2004 is substantially complete. The accounting staff has been cooperative with the audit team, providing detailed schedules and supporting documentation when requested. The CFO, however, has proven to be contentious when questioned about her accounting judgments. While she understands that there is always a learning curve to overcome when an auditor is assigned to an engagement for the first time, she seems increasingly annoyed with requests for additional information and explanations.

To date, all audit adjustments have been made and are reflected in the financial statements. The last account balance to be audited is the Estimated Liability for Warranties (See Schedules 1, 2, and 3).

SCHEDULE 1
Summary of Amounts Accrued and Actual Costs by Quarter
(in millions)

Current Year		Sales by Quarter	Warranty Accrual by Quarter (1)	Actual Warranty Claims to Date for Sales in Quarter (2)	Warranty Reserve Balance for Sales in Quarter (1) - (2)
2004	Q4	$3,175.00	15.88	0.45	15.43
2004	Q3	3,150.00	15.75	4.33	11.42
2004	Q2	3,100.00	62.00	16.12	45.88
2004	Q1	3,050.00	61.00	24.40	36.60
Total 2004 Warranty Expense			153.63		
Prior Year					
2003	Q4	3,090.00	61.80	35.23	26.57
2003	Q3	3,080.00	61.60	46.82	14.78
2003	Q2	3,100.00	62.00	55.18	6.82
2003	Q1	3,000.00	60.00	60.00	0.00
Estimated Liability Under Warranties					157.50

SCHEDULE 2
Summary of Actual Post Sale Warranty Costs
(in millions)

Period of Sale	Period in Which Claim was Submitted 2004 Q4	2004 Q3	2004 Q2	2004 Q1	2003 Q4	2003 Q3	2003 Q2	2003 Q1	Total
2004 Q4	0.45								0.45
2004 Q3	3.85	0.48							4.33
2004 Q2	9.92	5.58	0.62						16.12
2004 Q1	8.54	9.76	5.49	0.61					24.40
2003 Q4	10.51	8.65	9.89	5.56	0.62				35.23
2003 Q3	11.70	10.47	8.62	9.86	5.54	0.62			46.81
2003 Q2	8.06	11.78	10.54	8.68	9.92	5.58	0.62		55.18
2003 Q1	6.60	7.80	11.40	10.20	8.40	9.60	5.40	0.60	60.00

The company offers a two-year warranty on all of its products. Historically, the client has experienced warranty costs equal to about 1.5% to 2.5% of sales. Because of the materiality of the warranty liability and the length of the warranty period, the client and your firm agree that the cash

SCHEDULE 3
Comparison of Historical and Actual Warranty Claims Experience

	Historical Warranty Claims Experience* (previous five years)	Actual Warranty Claims as a Percent of Warranty Accrual (for 2003 and 2004)			
	Cumulative Percentage Claims Submitted	Period of Sale	Cumulative Actual Warranty Claims per Schedule 2 (1)	Amount of Accrual (per Schedule 1) (2)	Cumulative Claims Submitted as Percentage of Accrual for the Quarter (1)/(2)
In the quarter of the sale	1.0%*	2004 Q4	$0.45	$15.88	2.8%
One quarter after sale	10.0%*	2004 Q3	$4.33	$15.75	27.5%
Two quarters after sale	25.0%	2004 Q2	$16.12	$62.00	26.0%
Three quarters after sale	40.0%	2004 Q1	$24.40	$61.00	40.0%
Four quarters after sale	60.0%	2003 Q4	$35.23	$61.80	57.0%
Five quarters after sale	75.0%	2003 Q3	$46.81	$61.60	76.0%
Six quarters after sale	90.0%	2003 Q2	$55.18	$62.00	89.0%
Seven quarters after sale	100.0%	2003 Q1	$60.00	$60.00	100.0%

* This column shows the typical timing of warranty claims. For example, 1% of warranty claims for a quarter's sales are typically received in the quarter in which the sale was recorded. Ten percent of the total warranty claims for a quarter's sales are typically received within one quarter after the sale was recorded. One hundred percent of the total warranty claims for a quarter's sales are received within seven quarters after the sale was recorded (i.e., by the end of the two-year warranty period).

basis is not an acceptable method and the accrual method must be used. Under the accrual method, warranty costs are charged to operating expense in the year of the sale, and a corresponding liability is established. This liability is reduced when the actual warranty charges are incurred. In prior years, the client has reserved for warranty costs at the rate of 2% of sales.

Transactions affecting warranties are recorded as follows:

In the period of the sale:

Dr	Warranty Expense	XXX	
Cr	Estimated Liability for Warranties (the reserve)		XXX
	To accrue estimated warranty costs.		

After the sale, when actual warranty costs are incurred:

Dr	Estimated Liability for Warranties	XXX	
Cr	Cash, Inventory, or Accrued Payroll		XXX
	To record warranty costs incurred.		

Digicom has recently completed a modernization of its factory facilities and has implemented a total quality management (TQM) program. Management anticipates that process and product quality improvements resulting from the modernization and the TQM program will result in a significant decrease in warranty costs for products sold during the latter part of 2004. In anticipation of these future savings, the client has decreased its accrual of warranty expense in the third and fourth quarter of 2004 to .5% of sales, resulting in a total warranty expense for 2004 of $154,625,000. If the client had not decreased its accrual to .5% and they accrued at 2% for each quarter of 2004, then total warranty expense for 2004 would have been $249,500,000. Client management assures you that it will keep a close eye on actual warranty expenses and will adjust the reserve during the first quarter of 2005 if the anticipated savings do not materialize. Client management acknowledges that the effect of the proposed treatment of warranty costs results in a material change in an accounting estimate. Digicom has chosen not to disclose the effect of the change in estimate.

AUDIT TASK

Accounting Issue

The client and you agree that an accrual for warranties is necessary and is required under SFAS No. 5. The accounting issue relates to whether or not there is adequate evidence to support the company's change in the rate at which warranties are reserved (i.e., from 2% of sales to .5% of sales). If a change in estimate is made, the appropriate financial statement disclosure also must be determined.

As part of the audit, you are required to assess the adequacy of the Estimated Liability for Warranties and the related Warranty Expense. Since the plant modernization and the TQM program have only been in operation for six months, there are only two quarters of claims history for products produced after the new manufacturing system was put in place. Actual warranty claims for products sold in the third and fourth quarter of 2004 (the first two quarters after the new plant modernization and the TQM program) appear to have declined as compared with warranty claims submitted in the quarters immediately after the sale in prior comparable periods (See Schedule 2 – Summary of Actual Post Sale Warranty Costs). The client contends that this decline supports the change in estimate.

It appears, however, that the warranty reserve for third and fourth quarter 2004 sales is being depleted at a faster rate than would be expected, based on prior history of the timing of warranty claims. For example, historically, 10% of the warranty reserve for a particular quarter's sales is depleted within one quarter after the sale; for sales in third quarter 2004, 27.5% of the reserve has been depleted within one quarter after the sale. See Schedule 3 - Comparison of Historical and Actual Warranty Claims Experience. The client contends that the prior timing of claims may no longer be applicable.

Because of the uniqueness of the product, a track record of warranty claims after similar quality improvement initiatives at other companies was neither useful nor available, and discussions with Digicom personnel did not yield any additional insights. Therefore, no additional information is available beyond the material presented here. The audit report is due in less than one week, so there is no time for the development of additional history.

Other Information

The company is in compliance with its debt covenants. However, an increase in current liabilities of $50 million or more would result in a debt covenant violation. The lender has waived debt covenant violations on occasion; however, it is possible that the lender will not grant a waiver this year. If a waiver is needed and is not granted, a significant amount of long-term debt will become immediately due and payable. This would not create a substantial doubt about Digicom's continued existence as a going concern, but it is likely to cause a significant decline in the price of its stock.

CASE QUESTIONS

Accounting for Loss Contingencies

1. The liability for product warranties is an example of an accounting estimate for a loss contingency. Name two other types of loss contingencies. What are the criteria for determining whether or not to accrue or disclose a contingent liability?
2. What factors should management consider when establishing an estimate for the Liability under Warranties? How should an accountant and/or an auditor assess the adequacy of an accounting estimate?
3. Accounts involving estimates by management tend to be viewed as having a high amount of inherent risk. Why is this generally the case?

Questions related to the Digicom case

4. Accounting estimates are judgment-based decisions. Professional accountants are guided to consider both the allowability of an accounting treatment and the appropriateness of the accounting treatment in the circumstances.
    a. In the Digicom case, client management is proposing an accrual for warranties of .5% of sales and no disclosure of the change in estimate. Is client management's proposed treatment allowable under GAAP? Support your answer by referring to the appropriate authoritative guidance.
    b. Do you think that the accounting treatment proposed by client management is the most appropriate accounting treatment in the circumstances? Provide support for your answer. As the auditor for Digicom, would you allow the client to reduce the warranty accrual to .5% of sales in the third and fourth quarters, or would you require them to accrue at 2%, or would you be willing to compromise and meet somewhere in the middle? Justify your choice.
5. Client management and auditors face a variety of environmental factors that may influence their judgments. What are some of the environmental factors in the Digicom case that may influence client management and auditor judgments? What steps can/should the accounting profession take to reduce the likelihood of auditors succumbing to pressure from their clients?

6. Suppose as the auditor for Digicom, you disagreed with the client management's estimate of warranty/liability expense and the client refused to make the adjustment. Assume the adjustment is material. What options are available to the auditor?
7. Suppose as the auditor for Digicom, you disagreed with the client management's estimate of warranty liability/expense, however, the difference between your estimate and management's estimate is immaterial to the financial statements. What is your responsibility with respect to this audit difference?

General questions regarding the auditing and financial reporting environment

8. In the Digicom case, the audit committee is comprised of outside directors. They meet with the internal and external auditors several times each year. What is the role of the audit committee in today's audit environment?
9. Identify and discuss four actions that have recently been taken to strengthen the independent audit function. Do you believe the actions taken will have the desired effect on organizations and the reporting environment? Explain your answer.
10. What responsibilities do the CEOs and CFOs of public companies have with respect to the financial statements?
11. Where there is a choice among accounting alternatives, the conservatism concept guides accountants to choose the accounting treatment that is least likely to overstate net income. Are there situations where management may prefer to understate their net income? What is your opinion on the ethics of understating versus overstating net income?

REFERENCES

Financial Accounting Standards Board. 1975. *Accounting for Contingencies*. Statement of Financial Accounting Standards No. 5. (Stamford, CT: FASB).

TEACHING NOTES

Teaching notes are available from the editor. Send a request from the "For Contributors" page of the journal website, http://gpae.bryant.edu.