# Contingencies, Commitment & Offbalance Sheet

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# Contingencies and Commitments

## Basics of Contingencies

Contingencies **-- potential losses and gains whose resolution depends on one or more future events.**

Contingent liabilities **-- contingencies with potential claims on resources**

**-- to record a contingent liability (and loss) two conditions must be met:**

***(i) probable* an asset is impaired or a liability incurred, and**

**(ii)the amount of loss is *reasonably estimable*;**

**-- to disclose a contingent liability (and loss) there must be at least a *reasonable possibility* of incurrence**

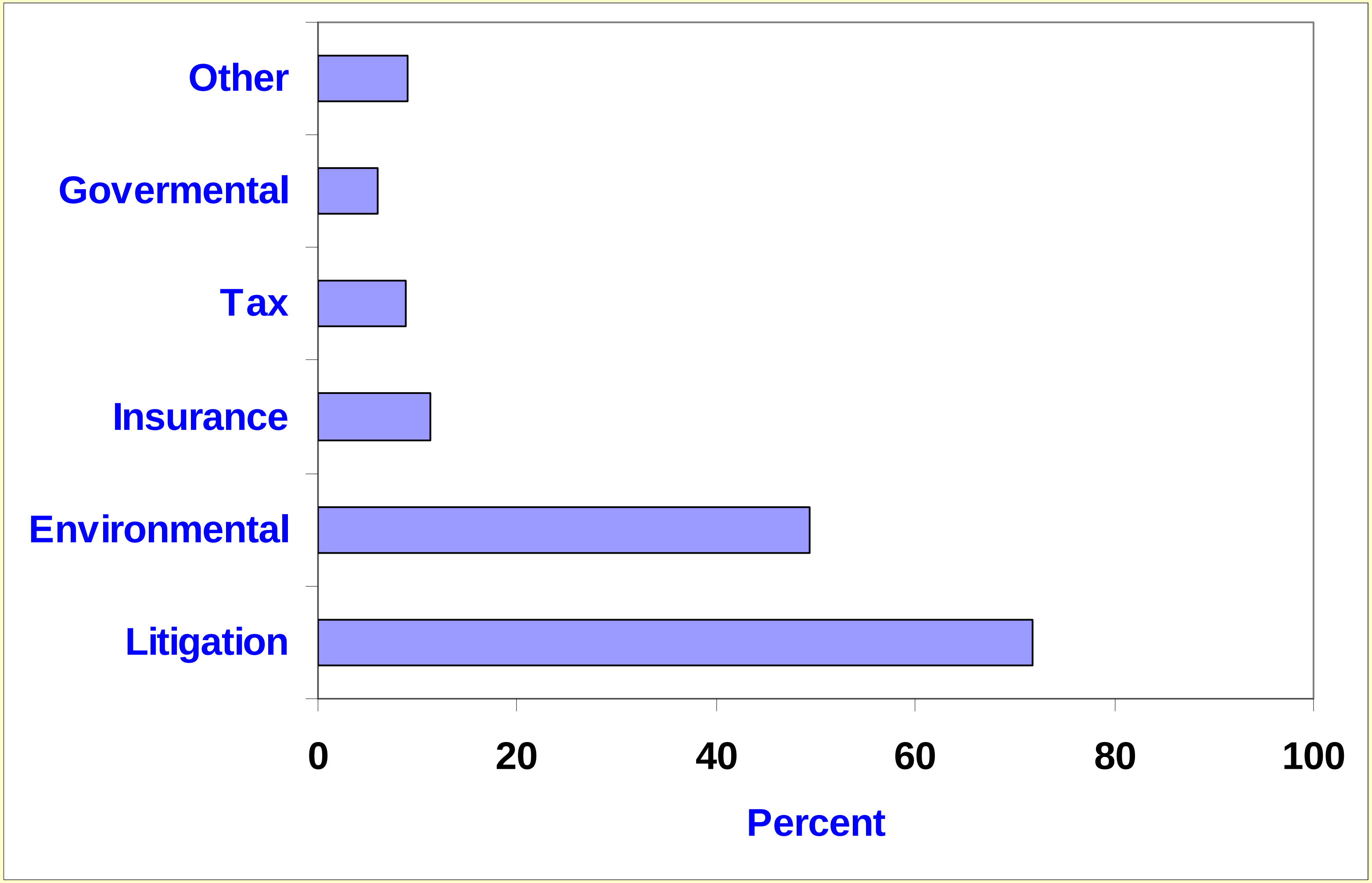
Contingent assets **-- contingencies with potential additions to resources**

**-- a contingent asset (and gain) is not recorded until the contingency is resolved**

**-- a contingent asset (and gain) can be disclosed if probability of realization is high**

# Contingencies and Commitments

## Frequency of Contingent Liabilities



# Contingencies and Commitments

## Analyzing Contingencies

Sources of useful information:

**Notes, MD&A, and Deferred Tax Disclosures**

Useful analyses:

- **Scrutinize management estimates**
- **Analyze notes regarding contingencies, including**
  - **Description of contingency and its degree of risk**
  - **Amount at risk and how treated in assessing risk exposure**
  - **Charges, if any, against income**
- **Recognize a bias to not record or underestimate contingent liabilities**
- **Beware of *big baths* — loss reserves are contingencies**
- **Review SEC filings for details of loss reserves**
- **Analyze deferred tax notes for undisclosed provisions for future losses**

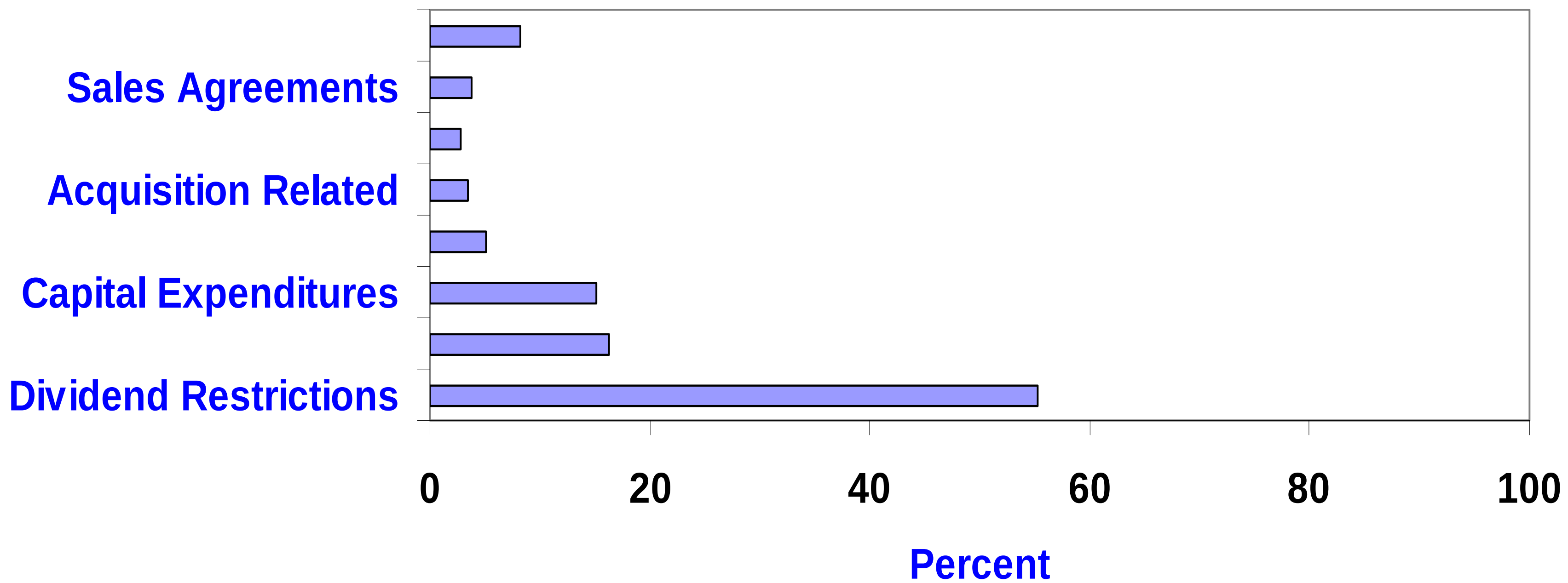
**Note: Loss reserves do not alter risk exposure, have no cash flow consequences, and do not provide insurance**

# Contingencies and Commitments

## Basics of Commitments

Commitments -- **potential claims against a company's resources due to future performance under contract**

## Frequency of Commitments



# Off-Balance-Sheet Financing

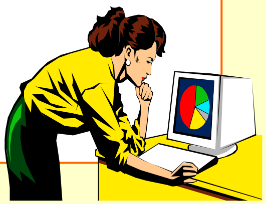
## Analyzing Commitments

Sources of useful information:

**Notes and MD&A and SEC Filings**

Useful analyses:

- **Scrutinize management communications and press releases**
- **Analyze notes regarding commitments, including**
  - **Description of commitment and its degree of risk**
  - **Amount at risk and how treated in assessing risk exposure**
  - **Contractual conditions and timing**
- **Recognize a bias to not disclose commitments**
- **Review SEC filings for details of commitments**



# Off-Balance-Sheet Financing

## Basics of Off-Balance-Sheet Financing

Off-Balance-Sheet Financing **-- is the non-recording of financing obligations**

Motivation

**To keep debt off the balance sheet—part of ever-changing landscape, where as one standard tries to better reflect obligations from a certain off-balance-sheet financing transaction, there are new and innovative means to take its place**

Transactions sometimes used as off-balance-sheet financing:

- **Operating leases that are indistinguishable from capital leases**
- **Through-put agreements, where a company agrees to run goods through a processing facility**
- **Take-or-pay arrangements, where a company guarantees to pay for goods whether needed or not**
- **Certain joint ventures and limited partnerships**
- **Product financing arrangements, where a company sells and agrees to either repurchase inventory or guarantee a selling price**
- **Sell receivables with recourse and record them as sales rather than liabilities**
- **Sell receivables as backing for debt sold to the public**
- **Outstanding loan commitments**

# Off-Balance-Sheet Financing

## Analysis of Off-Balance-Sheet Financing

Sources of useful information:

**Notes and MD&A and SEC Filings**

Companies disclose the following info about financial instruments with off-balance-sheet risk of loss:

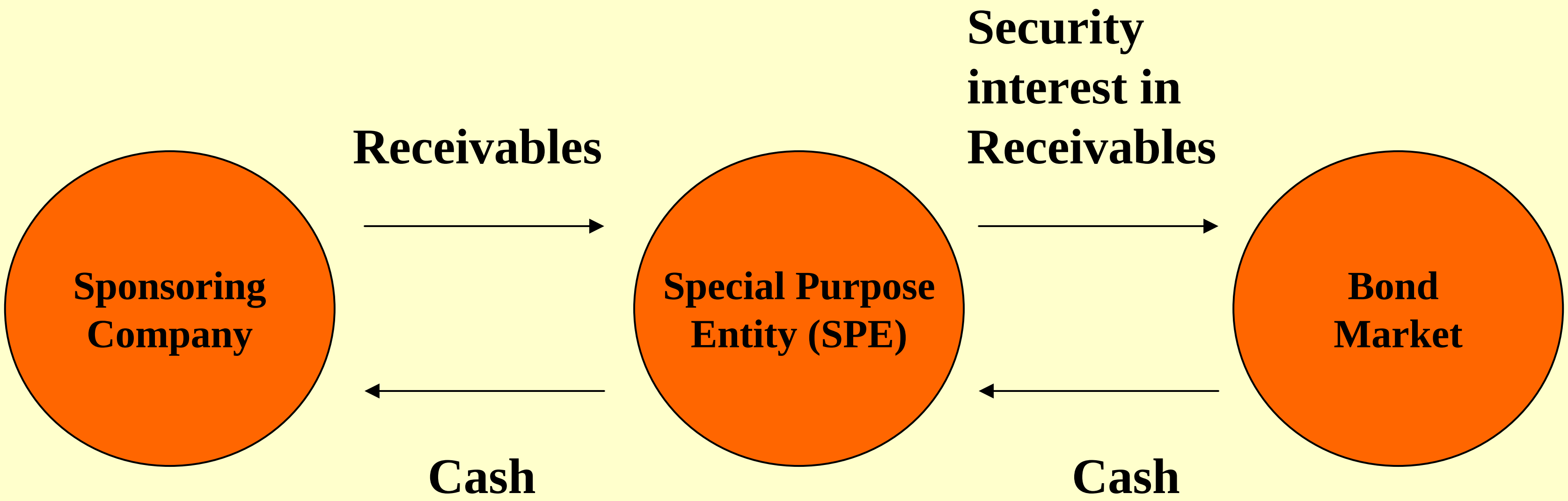
- **Face, contract, or principal amount**
- **Terms of the instrument and info on its credit and market risk, cash requirements, and accounting Loss incurred if a party to the contract fails to perform**
- **Collateral or other security, if any, for the amount at risk**
- **Info about concentrations of credit risk from a counterparty or groups of counterparties**

Useful analyses:

- **Scrutinize management communications and press releases**
- **Analyze notes about financing arrangements**
- **Recognize a bias to not disclose financing obligations**
- **Review SEC filings for details of financing arrangements**

# Off-Balance-Sheet Financing

## Illustration of SPE Transaction to Sell Accounts Receivable



# Shareholders' Equity

## Basics of Equity Financing


Equity — **refers to owner (shareholder) financing; its usual characteristics include:**
- **Reflects claims of owners (shareholders) on net assets**
- **Equity holders usually subordinate to creditors**
- **Variation across equity holders on seniority**
- **Exposed to maximum risk and return**

Equity Analysis — **involves analyzing equity characteristics, including:**
- **Classifying and distinguishing different equity sources**
- **Examining rights for equity classes and priorities in liquidation**
- **Evaluating legal restrictions for equity distribution**
- **Reviewing restrictions on retained earnings distribution**
- **Assessing terms and provisions of potential equity issuances**

Equity Classes — **two basic components:**
- **Capital Stock**
- **Retained Earnings**

# Shareholders' Equity

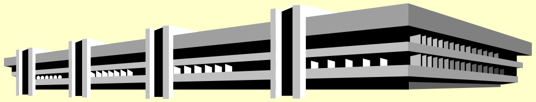
## Reporting Capital Stock

Sources of increases in capital stock outstanding:

- **Issuances of stock**
- **Conversion of debentures and preferred stock**
- **Issuances pursuant to stock dividends and splits**
- **Issuances of stock in acquisitions and mergers**
- **Issuances pursuant to stock options and warrants exercised**

Sources of decreases in capital stock outstanding:

- **Purchases and retirements of stock**
- **Purchases of treasury stock**
- **Reverse stock splits**

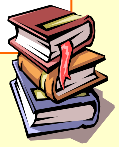


# Shareholders’ Equity

## Components of Capital Stock

Contributed (or Paid-In) Capital **— total financing received from shareholders for capital shares; usually consists of two parts:**

- **Common (or Preferred) Stock — financing equal to par or stated value;if stock is no-par, then equal to total financing**
- **Contributed (or Paid-In) Capital in Excess of Par or Stated Value — financing in excess of any par or stated value**



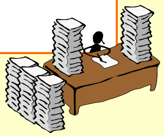
# Shareholders' Equity

## Two Types of Capital Stock

Preferred Stock **— capital stock with features not possessed by common stock; typical preferred stock features include:**

- **Dividend distribution preferences**
- **Liquidation priorities**
- **Convertibility (redemption) into common stock**
- **Call provisions**
- **Sinking fund provisions**

Common Stock **— capital stock with ownership interest and bearing ultimate risks and rewards (residual interests)**



# Shareholders' Equity

## Basics of Retained Earnings

Retained Earnings **— earned capital of a company; reflects accumulation of undistributed earnings or losses since inception; retained earnings is the main source of dividend distributions**

Cash and Stock Dividends

- **Cash dividend — distribution of cash (or assets) to shareholders**
- **Stock dividend — distribution of capital stock to shareholders**

Prior Period Adjustments **— mainly error corrections of prior periods' statements**

Appropriations of Retained Earnings **— reclassifications of retained earnings for specific purposes**

Restrictions (or Covenants) on Retained Earnings **— constraints or requirements on retention of retained earnings**