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Contingent Liabilities - Include or Not?

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Contingent Liabilities - Include or Not?

There is considerable concern within the accounting profession whether GAAP (Generally Accepted Accounting Procedures) should include contingencies in the financial statements of businesses. A contingency involves the potential gain or loss arising from an uncertain future event. The question then is, if there is the possibility of a future unexpected and unpredictable event involving financial loss, should financial reserves be dedicated to this so that the financial position of the firm is more accurately reported? While this issue of accurate financial reporting for contingencies is receiving attention for the benefit of investors in nonfarm business corporations, there are contingencies in the agricultural setting that should also be considered. Generally, potential losses receive the bulk of the attention as compared to gains. In agriculture, while disasters of the type described above are possible, it is income tax issues that are addressed here.

Nonfarm businesses face uncertainties that cannot be well predicted or insured against. These involve potential lawsuits, environmental damage claims, employee damage claims, unpredictable equipment failure and unpredictable losses intrinsic to that business. These events, for example, include airline crashes, pharmaceutical product damages, food product damages and environmental damage clean-up costs. Again, the issue is whether reserves should be placed in escrow for these possible events so that the business condition is more accurately reflected in the business reports. This issue may be very important to an investor who has little knowledge of the potential level of disasters in an industry or business compared to businesses in other industries. Currently, GAAP
provide for only a footnote in business reports for disclosing potential loss.

In farm businesses the setting of contingent outcomes generally is related to the accuracy of the balance sheet of the farm business of the owner(s) of that business. The contingencies are largely of a tax nature. Environmental damage claims against asset title holders are possible, but will not be discussed here. The contingent liability issue revolves around future and potential income tax liabilities which, if not recognized, may not only result in an inaccurate balance sheet but result in a financial shock at a future time. There are three issues that are important:

**1) Inventory Build Up**

Balance sheets for farm businesses are rarely constructed to provide an accurate estimate of the expected income tax liability at any point in time in the fiscal year. In other words, it is technically possible to maintain an income tax liability account at any time point, based on transactions incurred during the fiscal year and expected ones remaining. In this case, unusually high inventories can be included and their tax consequences recorded. However, it is not common to do this but only estimate an approximate income tax liability, which may be adjusted using judgement of the profitability for that fiscal year. In such a case, if there has been a significant build-up of grain and livestock inventories an additional income tax liability will eventually occur but not be noted on the balance sheet. Unless recognized, the liabilities are underestimated.

**2) Machinery and Equipment**

Where the tax basis of machinery and equipment is low or zero but the actual value higher, a tax liability will occur if sold. This, as with grain and livestock, may be realized only at a future time. If market values are used for these items, the liabilities are underestimated unless the contingent tax liabilities are included.

**3) Land Sales**

Unless held until death, land which has gained or lost value will involve a capital gain or loss. For those landowners who plan to sell land, the capital gain or loss tax consequences is still another item that will eventually occur and an accurate balance sheet will report the estimated liability. Owners who never sell land will not engage a capital gain or loss tax. Yet

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In conclusion, the issue is if future and uncertain income tax liabilities should be placed in balance sheets as “footnotes” or as actual estimated liabilities. For the first two (unusually high inventories and depreciated machinery and equipment) it would seem logical to include the tax consequences as a specific entry. For the land asset, the issue would seem to be decided by whether the intent is for eventual sale or not.