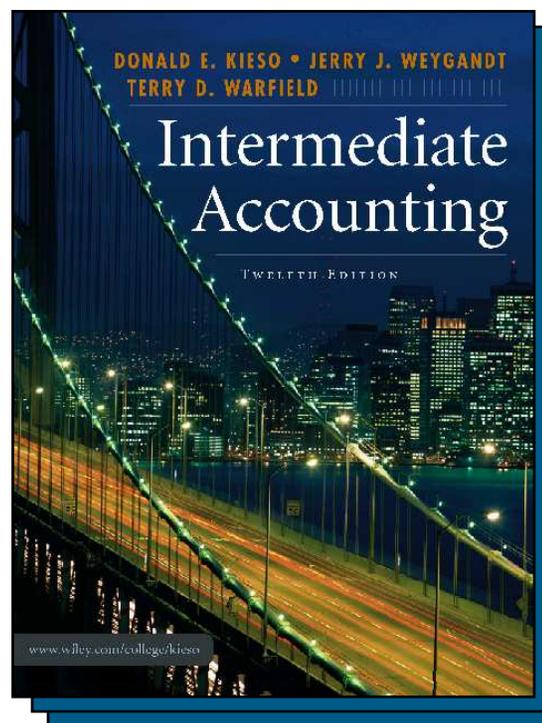


Accounting and Reporting of Current and Contingent Liabilities

Chapter 13

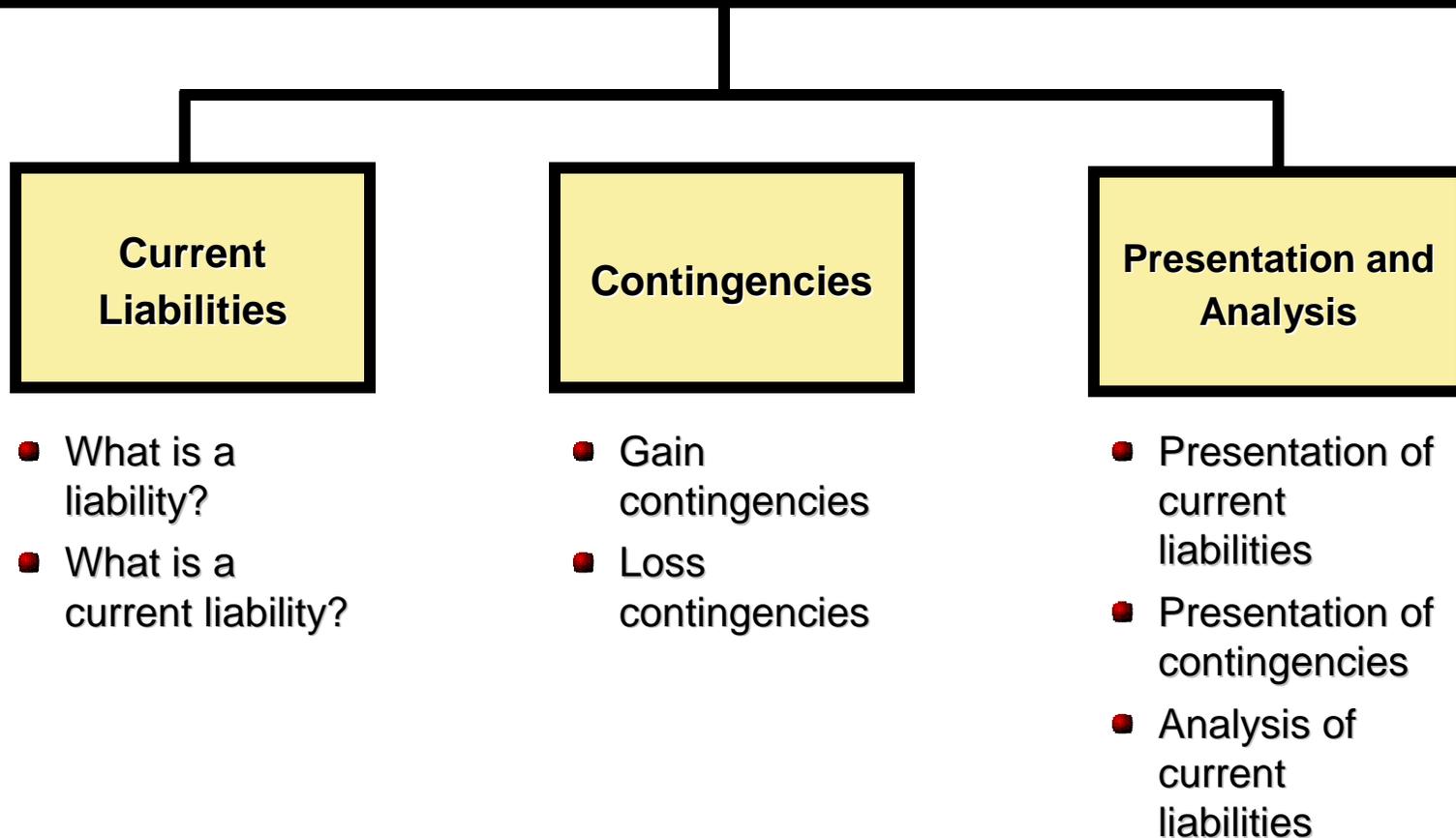
Intermediate Accounting
12th Edition
Kieso, Weygandt, and Warfield



Learning Objectives

1. Describe the nature, type, and valuation of current liabilities.
2. Explain the classification issues of short-term debt expected to be refinanced.
3. Identify types of employee-related liabilities.
4. Identify the criteria used to account for and disclose gain and loss contingencies.
5. Explain the accounting for different types of loss contingencies.
6. Indicate how to present and analyze liabilities and contingencies.

Current Liabilities and Contingencies



What is a Liability?

FASB, defines liabilities as:

"probable future sacrifices of economic benefits
arising from present obligations of a particular entity
to transfer assets or provide services to other
entities in the future as a result of past transactions
or events."

What is a Current Liability?

Current liabilities are “obligations whose liquidation is reasonably expected to require use of existing resources properly classified as current assets, or the creation of other current liabilities.”

Typical Current Liabilities:

- Accounts payable.
- Notes payable.
- Current maturities of long-term debt.
- Short-term obligations expected to be refinanced.
- Dividends payable.
- Customer advances and deposits.
- Unearned revenues.
- Sales taxes payable.
- Income taxes payable.
- Employee-related liabilities.

What is a Current Liability?

Accounts Payable (trade accounts payable)

Balances owed to others for goods, supplies, or services purchased on open account.

- Arise because of time lag between receipt of goods or services and the payment for them.
- The terms of the sale (e.g., 2/10, n/30) state period of extended credit.

What is a Current Liability?

Notes Payable

Written promises to pay a certain sum of money on a specified future date.

- Arise from purchases, financing, or other transactions.
- Notes classified as short-term or long-term.
- Notes may be interest-bearing or zero-interest-bearing.

What is a Current Liability?

E13-2 (Accounts and Notes Payable) The following are selected 2007 transactions of Sean Astin Corporation.

Sept. 1 - Purchased inventory from Encino Company on account for \$50,000. Astin records purchases gross and uses a periodic inventory system.

Oct. 1 - Issued a \$50,000, 12-month, 8% note to Encino in payment of account.

Oct. 1 - Borrowed \$50,000 from the Shore Bank by signing a 12-month, zero-interest-bearing \$54,000 note.

What is a Current Liability?

Sept. 1 - Purchased inventory from Encino Company on account for \$50,000. Astin records purchases gross and uses a periodic inventory system.

Sept. 1	Purchases	50,000	
	Accounts payable		50,000

What is a Current Liability?

Oct. 1 - Issued a \$50,000, 12-month, 8% note to Encino in payment of account.

Oct. 1	Accounts payable	50,000	
	Notes payable		50,000
Dec. 31	Interest expense	1,000	
	Interest payable		1,000
	(\$50,000 × 8% × 3/12)		

What is a Current Liability?

Oct. 1 - Borrowed \$50,000 from the Shore Bank by signing a 12-month, zero-interest-bearing \$54,000 note.

Oct. 1	Cash	50,000	
	Discount on notes payable	4,000	
	Notes payable		54,000
Dec. 31	Interest expense	1,000	
	Discount on notes payable (\$4,000 × 3/12)		1,000

What is a Current Liability?

Current Maturities of Long-Term Debt

Exclude long-term debts maturing currently as current liabilities if they are to be:

1. Retired by assets accumulated that have not been shown as current assets,
2. Refinanced, or retired from the proceeds of a new debt issue, or
3. Converted into capital stock.

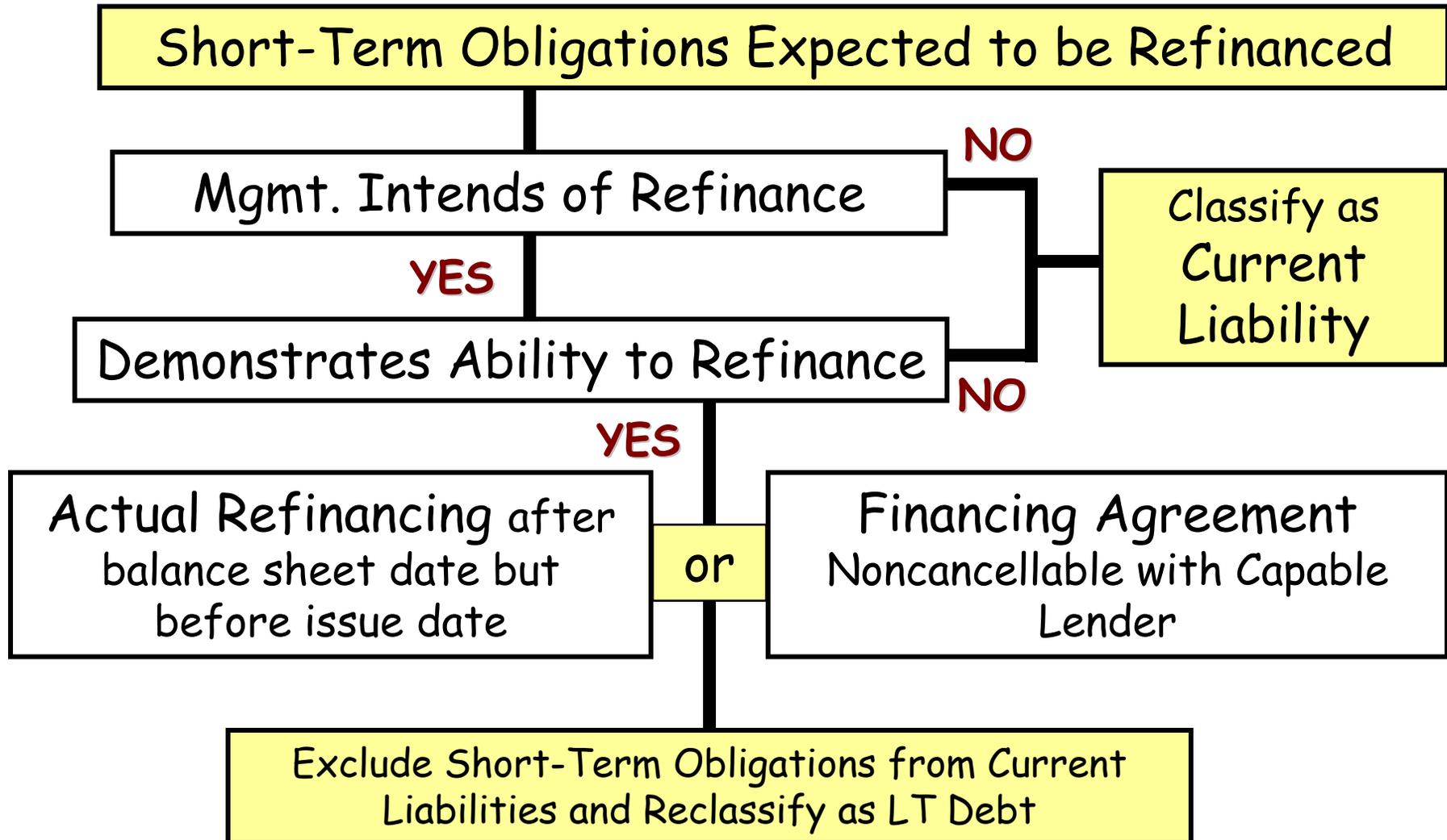
What is a Current Liability?

Short-Term Obligations Expected to Be Refinanced

Exclude from current liabilities if both of the following conditions are met:

1. Must **intend to refinance** the obligation on a long-term basis.
2. Must **demonstrate an ability** to refinance:
 - Actual refinancing
 - Enter into a financing agreement

What is a Current Liability?



What is a Current Liability?

E13-3 (Refinancing of Short-Term Debt) On December 31, 2007, Hattie McDaniel Company had \$1,200,000 of short-term debt in the form of notes payable due February 2, 2008. On January 21, 2008, the company issued 25,000 shares of its common stock for \$38 per share, receiving \$950,000 proceeds after brokerage fees and other costs of issuance. On February 2, 2008, the proceeds from the stock sale, supplemented by an additional \$250,000 cash, are used to liquidate the \$1,200,000 debt. The December 31, 2007, balance sheet is issued on February 23, 2008.

Instructions

Show how the \$1,200,000 of short-term debt should be presented on the December 31, 2007, balance sheet, including note disclosure.

What is a Current Liability?

Partial Balance Sheet

Current liabilities:

Notes payable	\$ 250,000
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Long-term debt:

Notes payable refinanced	<u>950,000</u>
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Total liabilities	<u>1,200,000</u>
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What is a Current Liability?

Dividends Payable

Amount owed by a corporation to its stockholders as a result of board of directors' authorization.

- Generally paid within three months.
- Undeclared dividends on cumulative preferred stock not recognized as a liability.
- Dividends payable in the form of shares of stock are not recognized as a liability. Reported in equity.

What is a Current Liability?

Customer Advances and Deposits

Include returnable cash deposits received from customers and employees.

- May be classified as current or long-term.

What is a Current Liability?

Unearned Revenues

Payment received before delivering goods or rendering services?

Unearned and Earned Revenue Accounts

Illustration 13-3

Type of Business	Account Title	
	Unearned Revenue	Earned Revenue
Airline	Unearned Passenger Ticket Revenue	Passenger Revenue
Magazine publisher	Unearned Subscription Revenue	Subscription Revenue
Hotel	Unearned Rental Revenue	Rental Revenue
Auto dealer	Unearned Warranty Revenue	Warranty Revenue
Retailers	Unearned Gift Card Revenue	Sales Revenue

What is a Current Liability?

BE13-5 Game Pro Magazine sold 10,000 annual subscriptions on August 1, 2007, for \$18 each. Prepare Game Pro's August 1, 2007, journal entry and the December 31, 2007, annual adjusting entry.

Aug. 1	Cash	180,000	
	Unearned revenue		180,000
	(10,000 × \$18)		

Dec. 31	Unearned revenue	75,000	
	Subscription revenue		75,000
	(\$180,000 × 5/12 = \$75,000)		

What is a Current Liability?

Sales Taxes Payable

Retailers must collect sales taxes from customers on transfers of tangible personal property and on certain services and then remit to the proper governmental authority.

What is a Current Liability?

BE13-6 Flintstones Corporation made credit sales of \$30,000 which are subject to 6% sales tax. The corporation also made cash sales which totaled \$19,610 including the 6% sales tax. (a) prepare the entry to record Flintstones' credit sales. (b) Prepare the entry to record Flintstones' cash sales.

Accounts receivable	31,800	
Sales		30,000
Sales tax payable		1,800
(\$30,000 × 6% = \$1,800)		
Cash	19,610	
Sales		18,500
Sales tax payable		1,110
(\$19,610 ÷ 1.06 = \$18,500)		

What is a Current Liability?

Income Tax Payable

Businesses must prepare an income tax return and compute the income tax payable resulting from the operations of the current period.

- Taxes payable are a current liability
- Corporations must make periodic tax payments throughout the year.
- Differences between taxable income and accounting income sometimes occur (Chapter 19).

What is a Current Liability?

Employee-Related Liabilities

Amounts owed to employees for salaries or wages are reported as a current liability.

In addition, current liabilities may include:

- Payroll deductions.
- Compensated absences.
- Bonuses (Appendix 13A).

What is a Current Liability?

Payroll Deductions

Taxes:

- Social Security Taxes
- Unemployment Taxes
- Income Tax Withholding

What is a Current Liability?

Exercise Assume a weekly payroll of \$10,000 entirely subject to F.I.C.A. and Medicare (7.65%), federal (0.8%) and state (4%) unemployment taxes, with income tax withholding of \$1,320 and union dues of \$88 deducted. The company records the **salaries and wages paid** and the **employee payroll deductions** as follows:

Journal entry to record salaries and wages paid:

Salaries and wages expense	10,000	
Withholding taxes payable		1,320
F.I.C.A taxes payable		765
Union dues payable		88
Cash		7,827

What is a Current Liability?

Exercise Assume a weekly payroll of \$10,000 entirely subject to F.I.C.A. and Medicare (7.65%), federal (0.8%) and state (4%) unemployment taxes, with income tax withholding of \$1,320 and union dues of \$88 deducted. The company records the salaries and wages paid and the employee payroll deductions as follows:

Journal entry to record employer payroll taxes:

Payroll tax expense	1,245	
F.I.C.A taxes payable		765
Federal unemployment tax payable		80
State unemployment tax payable		400

What is a Current Liability?

Compensated Absences

Paid absences for vacation, illness, and holidays.

Accrue a liability if all the following conditions exist.

- The employer's obligation is attributable to employees' services already rendered.
- The obligation relates to rights that vest or accumulate.
- Payment of the compensation is probable.
- The amount can be reasonably estimated.

What is a Current Liability?

Bonus Agreements

Result in payments to certain or all employees in addition to their regular salaries or wages.

- Bonuses paid are an operating expense.
- Unpaid bonuses should be reported as a current liability.

Contingencies

"An existing condition, situation, or set of circumstances involving uncertainty as to possible gain (**gain contingency**) or loss (**loss contingency**) to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur."*

*"Accounting for Contingencies," *Statement of Financial Accounting Standards No. 5* (Stamford, Conn.: FASB, 1975), par. 1

Gain Contingencies

Typical Gain Contingencies are:

- Possible receipts of monies from gifts, donations, and bonuses.
- Possible refunds from the government in tax disputes.
- Pending court cases with a probable favorable outcome.
- Tax loss carryforwards (Chapter 19).

Gain contingencies are **not recorded**.

Disclosed only if probability of receipt is high.

Loss Contingencies

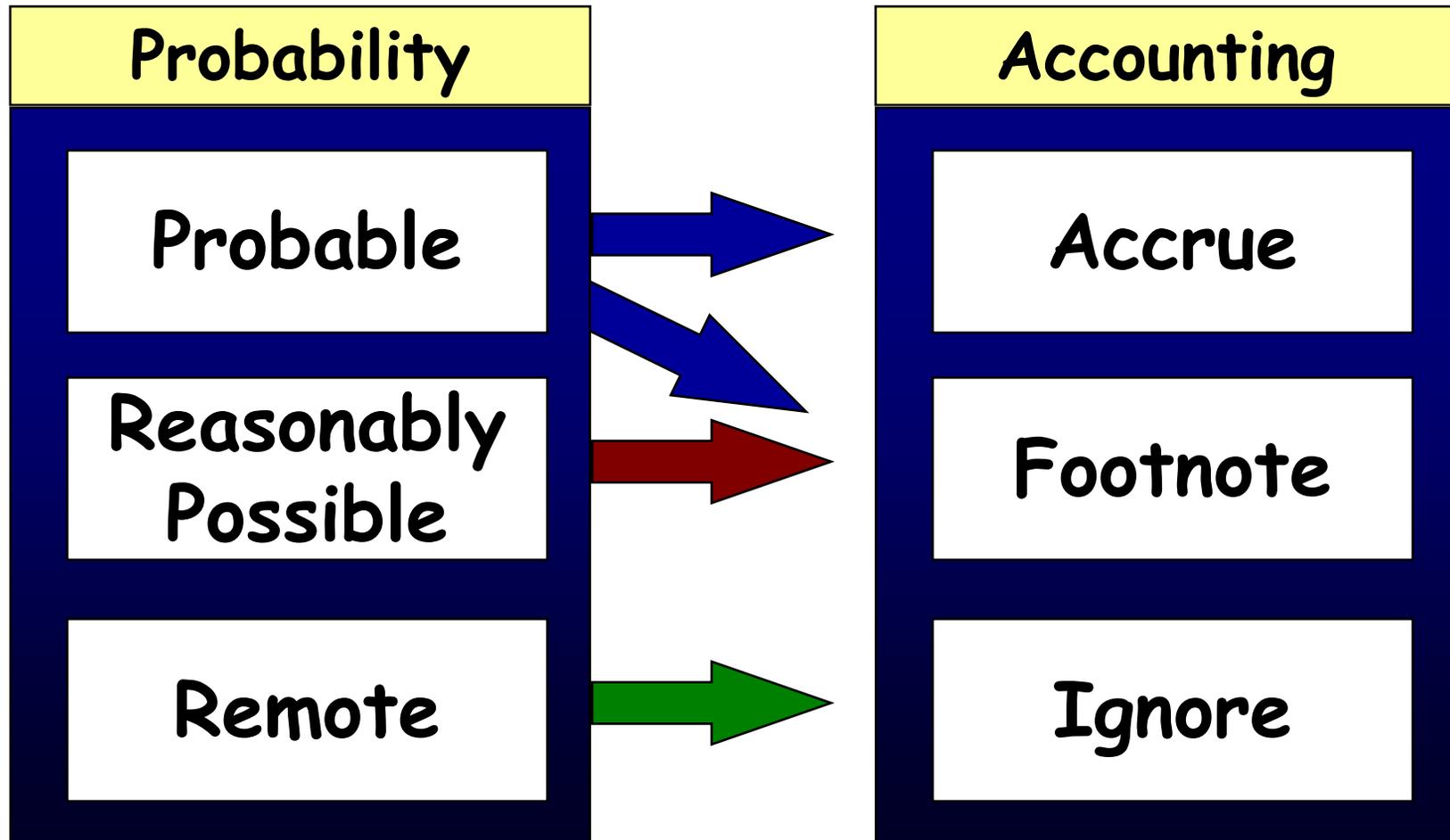
Contingent Liability

The likelihood that the future event will confirm the incurrence of a liability can range from probable to remote.

FASB uses three areas of probability:

- Probable.
- Reasonably possible.
- Remote.

Loss Contingencies



Loss Contingencies

BE13-10 Justice League Inc. is involved in a lawsuit at December 31, 2007. (a) Prepare the December 31 entry assuming it is probable that Justice League will be liable for \$700,000 as a result of this suit. (b) Prepare the December 31 entry, if any, assuming it is *not* probable that Justice League will be liable for any payment as a result of this suit.

(a)	Lawsuit loss	700,000	
	Lawsuit liability		700,000

(b) No entry is necessary. The loss is not accrued because it is not probable that a liability has been incurred at 12/31/07.

Loss Contingencies

Common loss contingencies:

1. Litigation, claims, and assessments.
2. Guarantee and warranty costs.
3. Premiums and coupons.
4. Environmental liabilities.

Loss Contingencies

Litigation, Claims, and Assessments

Companies must consider the following factors, in determining whether to record a liability with respect to **pending** or **threatened litigation** and actual or possible **claims** and **assessments**.

- Time period in which the action occurred.
- Probability of an unfavorable outcome.
- Ability to make a reasonable estimate of the loss.

Loss Contingencies

Guarantee and Warranty Costs

Promise made by a seller to a buyer to make good on a deficiency of quantity, quality, or performance in a product.

If it is probable that customers will make warranty claims and a company can reasonably estimate the costs involved, the company must record an expense.

Loss Contingencies

BE13-13 Frantic Factory provides a 2-year warranty with one of its products which was first sold in 2007. In that year, Frantic spent \$70,000 servicing warranty claims. At year-end, Frantic estimates that an additional \$500,000 will be spent in the future to service warranty claims related to 2007 sales. Prepare Frantic's journal entry to record the \$70,000 expenditure, and the December 31 adjusting entry.

2007	Warranty expense	70,000	
	Cash		70,000
12/31/07	Warranty expense	500,000	
	Warranty liability		500,000

Loss Contingencies

Premiums and Coupons

Companies should charge the costs of premiums and coupons to expense in the period of the sale that benefits from the plan.

Accounting:

- Company estimates the number of outstanding premium offers that customers will present for redemption.
- Company charges the cost of premium offers to Premium Expense and credits Estimated Liability for Premiums.

Loss Contingencies

Environmental Liabilities

A company must recognize an **asset retirement obligation (ARO)** when it has an existing legal obligation associated with the retirement of a long-lived asset and when it can reasonably estimate the amount of the liability.

Presentation and Analysis

Presentation of Current Liabilities

- Usually reported at their full maturity value.
- Difference between present value and the maturity value is considered immaterial.

Presentation of Contingencies

Disclosure should include:

- Nature of the contingency.
- An estimate of the possible loss or range of loss.

Presentation and Analysis

Analysis of Current Liabilities

Liquidity regarding a liability is the expected time to elapse before its payment. Two ratios to help assess liquidity are:

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

$$\text{Acid-Test Ratio} = \frac{\text{Cash + Marketable Securities + Net Receivables}}{\text{Current Liabilities}}$$

Presentation and Analysis

E13-17 (Ratio Computations and Discussion) Sprague Company has been operating for several years, and on December 31, 2007, presented the following balance sheet.

Balance Sheet (in thousands)	
Assets	
Cash	\$ 40,000
Accounts receivables, net	75,000
Inventories	95,000
Plant assets, net	220,000
Total assets	<u>\$ 430,000</u>
Liabilities and Equity	
Accounts payable	\$ 80,000
Mortgage payable	140,000
Common stock, \$1 par	150,000
Retained earnings	60,000
Total liabilities and equity	<u>\$ 430,000</u>

Compute the **current ratio**:

$$\frac{\$210,000}{80,000} = 2.63 \text{ to } 1$$

Compute the **acid-test ratio**:

$$\frac{\$115,000}{80,000} = 1.44 \text{ to } 1$$

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