

# Current Liabilities and Contingencies

# Describe the nature, type, and valuation of current liabilities

## What is a Liability?”

- The **FASB**, defined 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.”

# Current Liabilities

**Recall: Current assets** are cash or other assets that companies reasonably expect to convert into cash, sell, or consume in operations within a single operating cycle or within a year.

**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.”

**Operating cycle:** period of time elapsing between the acquisition of goods and services and the final cash realization resulting from sales and subsequent collections.

# 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



# Accounts Payable (Trade accounts payable)

- Balances owed to others for goods, supplies, or services purchased on open account.
  - ◆ Time lag between the receipt of services or acquisition of title to assets and the payment for them.
  - ◆ Terms of the sale (e.g., 2/10, n/30 or 1/10, E.O.M.) usually state period of extended credit, commonly 30 to 60 days.

# Notes payable

- Written promises to pay a certain sum of money on a specified future date.
  - ◆ Arise from purchases, financing, or other transactions.
  - ◆ Classified as short-term or long-term.
  - ◆ May be interest-bearing or zero-interest-bearing.



# Interest-Bearing Note Issued

Castle National Bank agrees to lend \$100,000 on March 1, 2014, to Landscape Co. if Landscape signs a \$100,000, 6 percent, four-month note. Landscape records the cash received on March 1 as follows:

Cash	100000	
Notes payable		100000



# Interest-Bearing Note Issued

If Landscape prepares financial statements semiannually, it makes the following adjusting entry to recognize interest expense and interest payable at June 30:

$$\text{Interest expense} = (\$100,000 \times 6\% \times 4/12) = \$2,000$$

Interest Expense	2000	
Interest payable		2000





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## Interest-Bearing Note Issued

- At maturity (July 1), Landscape records payment of the note and accrued interest as follows.

Notes payable	100000	
Interest payable	2000	
Cash		102000



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## Zero-Interest-Bearing Note Issued

On March 1, Landscape issues a \$102,000, four-month, zero-interest-bearing note to Castle National Bank. The present value of the note is \$100,000. Landscape records this transaction as follows.

Cash	100000	
Discount on Notes Payable	2000	
Notes payable		102000



# Discount on Notes Payable

Discount on Notes Payable is a contra account to Notes Payable, and therefore is subtracted from Notes Payable on the balance sheet.

<b><u>Current Liabilities</u></b>		
Notes payable	102000	
Less: Discount on notes payable	(2000)	100000



# Discount on Notes Payable

## Discount on notes payable:

- ◆ Represents the cost of borrowing.
- ◆ Debited to interest expense over the life of the note.
- ◆ Represents interest expense chargeable to future periods.



# Current Liabilities

The following are selected transactions of Darby Corporation.

- **Sept. 1** - Purchased inventory from Orion Company on account for \$50,000.
- **Oct. 1** - Issued a \$50,000, 12-month, 8% note to Orion in payment of account.
- **Oct. 1** - Borrowed \$75,000 from the Shore Bank by signing a 12-month, zero-interest-bearing \$81,000 note.

Prepare journal entries for the selected transactions.

# Current Liabilities

Sep 1	Inventory		50000	
		Accounts payable		50000
Oct 1	Accounts payable		50000	
		Notes payable		50000
Dec 31	Interest Expense ( $\$50,000 \times 8\% \times 3/12$ )		1000	
		Interest Payable		1000



# Zero-Interest-Bearing Note Issued

- Oct. 1 - Borrowed \$75,000 from the Shore Bank by signing a 12-month, zero-interest-bearing \$81,000 note.

Oct1	Cash	75000	
	Discount on Notes Payable	6000	
	Notes payable		81000
Dec31	Interest Expense ( $\$6,000 \times 3/12$ )	1500	
	Discount on Notes Payable		1500

# 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 additional shares of stock are reported in stockholders' equity.





# Customer Advances and Deposits

- **Returnable cash deposits** received from customers and employees.
  - To guarantee performance of a contract or service or
  - As guarantees to cover payment of expected future obligations.
  - May be classified as **current** or **long-term** liabilities.

# Unearned Revenues

Payment received before delivering goods or rendering services?

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

## Current Liabilities

Allstate University sells 10,000 season football tickets at \$50 each for its five-game home schedule. Allstate University records the sales of season tickets as follows.

Aug 6	Cash	500000	
	Unearned Sales Revenue		500000
	(10000× 50=500000)		

# Current Liabilities

As each game is completed, Allstate makes the following entry.

Dec 31	Unearned Sales Revenue		100000	
		Sales Revenue		100000
	(500000 ÷ 5 games = 100000 per game)			



# 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.

## Current Liabilities

- Prepare the entry to record sales taxes assuming there was a sale of \$3,000 when a 4 percent sales tax is in effect.

Date	Cash		3120	
		Sales Revenue		3000
		Sales Taxes Payable (\$3000×4%)		120

## Current Liabilities

Many companies do not segregate the sales tax and the amount of the sale at the time of sale. Instead, the company credits both amounts in total in the Sales Revenue account.

# Current Liabilities

- Assume the Sales Revenue account balance of \$150,000 includes sales taxes of 4 percent. Prepare the entry to record the amount due the taxing unit.

Date	Sales Revenue		5769.23	
		Sales Taxes Payable		5769.23
	$(\$150,000 \div 1.04 = \$144,230.77 - \$150,000 = \$5,769.23)$			



# Income Tax Payable

- Businesses must prepare an income tax return and compute the income tax payable.
  - ◆ Taxes payable are a current liability.
  - ◆ Corporations must make periodic tax payments.
  - ◆ Differences between taxable income (tax law) and accounting income (GAAP) sometimes occur



# Employee-Related Liabilities

- Amounts owed to employees for salaries or wages are reported as a current liability.
- Current liabilities related to employee compensation may include:
  - ◆ Payroll deductions.
  - ◆ Compensated absences.
  - ◆ Bonuses.

# Payroll Deductions

- Most common types of payroll deductions are taxes, insurance premiums, employee savings, and union dues.

**Illustration:** 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:

# Current Liabilities

Date	Salaries and Wages Expense	10000	
	Withholding Taxes payable		1320
	FICA Taxes Payable		765
	Union Dues Payable		88
	Cash		7827

# Current Liabilities

**Illustration:** 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 employers payroll taxes as follows:

# Current Liabilities

Date	Payroll Tax Expense	1245	
	FICA Taxes Payable		765
	FUTA Taxes Payable		80
	SUTA Taxes Payable		400