Chapter 13
Part 1 - Current Liabilities

Intermediate Accounting II Dr. Chula King

Student Learning Outcomes

- Define liabilities and distinguish between current and long-term
- Account for issuance and payment of various forms of notes, and record interest on the notes
- Characterize accrued liabilities and liabilities from advance collections and describe when and how they should be recorded
- Determine when a current liability can be classified as a noncurrent obligation
- Part 2 - Contingencies

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Definition of Liability

- **Probable** future sacrifice of economic benefit arising from a **present** obligation to transfer assets or provide services to other entities in the **future** as a result of **past** transactions or events.

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Categorization of Liabilities

- Current – expected to require the use of current assets and usually payable within one year.
- Long-term – if not current

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Types of Current Liabilities

- Definite as to existence AND reasonably capable of estimation as to amount, e.g., accounts payable, notes payable, taxes payable, accrued liabilities
- Definite as to existence BUT uncertain as to amount, e.g., warranties, premiums
- Uncertain as to existence AND uncertain as to amount, e.g., loss contingencies

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Accounting Issues

- Creation or incurrence of liability
- Accounting for liability while held
- Satisfaction of liability

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Open Accounts and Notes

- Accounts payable – obligations to suppliers for goods purchased on open account
- Trade notes payable – similar to accounts payable, but recognized by a written promissory note
- Short-term notes payable – cash borrowed from the bank and recognized by a promissory note
- Credit lines – prearranged agreements with the bank that allow a company to borrow cash without having to follow the normal loan procedures and paperwork

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Interest

- Cost of borrowing money
- Interest = Face amount of note x Annual interest rate x Time period involved
- For Example: On November 1, 2013, Apex, Inc., borrowed $10,000 from the bank. The note is due in 6 months, on May 1, 2014, and has a stated interest rate of 6%.
- Let's look at the journal entries!

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For Example (continued)

11/1/13	Cash	10,000	
	Note Payable		10,000
12/31/13	Interest Expense	100	
	Interest Payable		100
	(10,000 x 6%) x 2/12		
5/1/14	Note Payable	10,000	
	Interest Payable	100	
	Interest Expense*	200	
	Cash		10,300
	*(10,000 x 6%) x 4/12		

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Noninterest Bearing Note

- Notes without stated interest rate
- Implicit or effective interest
- Face of note includes amount borrowed, plus implicit interest

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For Example

- On June 1, Apex, Inc., a calendar year company, issued a one-year, noninterest bearing note with a face amount of $10,600, in exchange for a piece of equipment valued at $10,000.

6/1	Equipment	10,000	
	Discount on Notes Payable	600	
	Notes Payable		10,600

- Interest implicit in the note is $600, recorded as Discount on Notes Payable (contra liability)

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For Example (continued)

12/31	Interest Expense (600 x 7/12)	350	
	Discount on Notes Payable		350
5/31	Interest Expense (600 x 5/12)	250	
	Discount on Notes Payable		250
	Notes Payable	10,600	
	Cash		10,600

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Commercial Paper

- Unsecured note issued in minimum denominations of $25,000
- Maturities range from 30 to 270 days
- Issued directly to the lender; backed by bank line of credit
- Recorded in the same manner as notes payable

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Salaries, Commissions, Bonuses

- Accrual basis – expenses incurred but not yet paid
- Compensation such as salaries, commissions, and bonuses
  - Recorded as expense when paid
  - Accrued as expense with related liability at balance sheet date if incurred, but not yet paid (adjusting entry)

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Vacations, Sick Days, etc.

- Accrual of expense and related liability at the current wage rate for employee compensation for future absences such as vacation pay if the following four conditions are met
  - Obligation is for services already performed
  - Paid absence can be taken in a later year – the benefit vests or the benefit can be accumulated over time
  - Payment is probable
  - Amount can be reasonably estimated

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For Example

- Apex, Inc., provides each of its 8,000 employees 2-weeks of paid vacation per year. Vacation time not taken in the year can be carried over to subsequent years. During 2013, 2,500 employees took both weeks of vacation. 2,000 employees took 1 week of vacation, and 3,500 employees took none of the vacation. The average salary per employee per week was $600.

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For Example (continued)

- ***Entry to record vacation taken in 2013:***

Wages expense	4,200,000	
Cash (or wages payable)		4,200,000

(2,500 x 2 x $600) + (2,000 x 1 x $600)

- ***Entry to record vacation not taken in 2013:***

Wages expense	5,400,000	
Liability for future vacation		5,400,000

(2,000 x 1 x $600) + (3,500 x 2 x $600)

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For Example (continued)

- In 2014, when the remaining 9,000 vacation days from 2013 were taken, the average employee salary had increased to $650 per week.

Liability for future vacations	5,400,000	
Wages expense (9,000 x $50)	450,000	
Cash (or wages payable)		5,850,000*

*9,000 x $650

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Liabilities for Advance Collections

- Refundable deposits
- Advances from customers (unearned revenue)
- Gift cards (unearned revenue)
- Collections for third parties

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For Example

- During the December 2012 Christmas promotion, Apex, Inc., sold 20,000 gift cards at $25 each. All gift card sales were for cash. On December 31, 2012, only 1,000 gift cards had been redeemed. Unused gift cards expire on December 31, 2013. By December 31, 2013, 18,500 additional gift cards had been redeemed. The remaining 500 gift cards had not been redeemed, and therefore expired.

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For Example (continued)

2012:		
Cash (20,000 x $25)	500,000	
Unearned revenue		500,000
Unearned revenue (1,000 x $25)	25,000	
Sales revenue		25,000
2013:		
Unearned revenue (18,500 x $25)	462,500	
Sales revenue		462,500
Unearned revenue (500 x $25)	12,500	
Revenue from expired gift cards		12,500

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Current Maturities of Long-term Obligations

- Generally reclassified and reported as current liabilities if payable within the upcoming year (or the operating cycle, if longer than a year)
  - For example, a 20-year bond issue is classified as long-term for 19 years, but is reported as current during the 20th year of its term to maturity
- Debt that is callable by the lender in the coming year (or operating cycle, if longer) should be classified as a current liability, even if the debt is not expected to be called

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Short-term Obligations Expected to be Refinanced

- Company may classify short term liability as long term if the company has:
  - The intent to refinance on a long-term basis; AND
  - Demonstrated the ability to refinance
- Ability to refinance on long-term basis demonstrated by
  - An existing financing agreement; OR
  - Actual financing prior to issuance of financial statements

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The Next Step

- Part 2 - Contingencies

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