

# ACC101 – CHAPTER 9

## Accounting for Current Liabilities



## Key Terms and Concepts to Know

### **Liabilities**

Definition

Past/Present/Future elements

### **Classification**

Current

Long-term

### **Uncertainty**

Amount

Payee

Payment date

### **Types of known liabilities**

### **Estimated liabilities**

### **Contingent liabilities**

## **DEFINITION AND PAST/PRESENT/FUTURE ELEMENTS**

1. A liability is a debt owed to a third party; a company cannot have a liability to itself.
2. A liability requires all three of the following elements to be present in order to be recorded: a **PAST** event must have occurred which results in **PRESENT** obligation to pay a third party which will be paid at some **FUTURE** date.
3. A liability may be satisfied by the exchange of cash or other assets or by providing services.
4. For example, when a company turns on the lights, electricity is consumed (PAST) which results in an amount owed to the utility (PRESENT) which will be paid after the invoice arrives (FUTURE).

## **CLASSIFICATION**

1. Just as for assets, liabilities are classified as current or long-term, depending on the due date.
2. Current liabilities are due to be paid within the next twelve months.
3. Long-term liabilities are due to be paid after the next twelve months have passed.
4. Liabilities which require payments during the next twelve months and after the next twelve months must be analyzed and separated into their current and long-term components. For example, a contract for marketing services which requires a series of 5 annual payments beginning at the end of the first year would be recorded as both a current liability for the first payment and a long-term liability for the subsequent 4 payments.

## **UNCERTAINTY**

Uncertainty arises because a liability may be incurred before all the facts are known. For example, an insurance company insures homes in an area known to have frequent tornadoes. The insurance company knows that a tornado will occur at some time in the future. However, the insurance company does not know when the tornado will occur (WHEN TO PAY), how severe the resulting damage will be (HOW MUCH TO PAY) or whose homes will be damaged (WHOM TO PAY). However, the insurance company is required to use its best judgment and record an estimated liability for the future claims payments.

## **KNOWN LIABILITIES**

Known liabilities involve little, if any, uncertainty. Whom to pay, when to pay and how much to pay are definitely determinable. In previous chapters, many of the most common known liabilities have been discussed:

- Accounts Payable
- Sales Taxes Payable
- Unearned Revenues

Known liabilities include short-term notes payable.

## **NOTES PAYABLE**

Notes Payable are promissory notes given that state a promise to pay a specific dollar amount, usually with interest, within a specified time period. They are the “opposite” of the notes receivable discussed in the chapter on accounts receivable.

With an interest-bearing note, the interest expense is recorded when the note is paid.

- Notes Receivable generate Interest Income
- Notes Payable generate Interest Expense

### **Example #1**

A business issues a 90-day, 10% note for \$12,000 to a creditor for an overdue account.

### **Entry to record issuance of the note**

Accounts Payable	12,000	
Notes Payable		12,000

### **Entry to record payment of the note**

*Interest: 12,000 \* .10 \* 90/360 = 300*

Notes Payable	12,000	
Interest Expense	300	
Cash		12,300

**Discounted Notes** – Non-interest bearing notes may be given to a creditor who “discounts them”—deducts his discount (interest) in advance. The interest expense is recorded when the note is issued.

**Example #2**

Aztec, Inc. borrowed 21,000 from First National Bank issuing a 120-day non-interest bearing note. The bank discounted the note at 12%.

**Entry to record issuance of the note**

Discount:  $21,000 * .12 * 120/360 = 840$

Proceeds:  $21,000 - 840 = 20,160$

Cash	20,160	
Interest Expense	840	
Notes Payable		21,000

**Entry to record payment of the note**

Notes Payable	21,000	
Cash		21,000

**Accrual of Interest** – Interest Expense must be accrued on all outstanding Notes Payables at the end of the accounting period to properly match revenues and expenses.

**Example #3**

On December 1, issued a 60-day, 8% note for \$15,000 on account. Journalize the entry to accrue interest expense on December 31.

There are 30 days left in the period (December 1 through December 31)

Interest Expense =  $15,000 * .08 * 30/360 = 100$

Interest Expense	100	
Interest Payable		100

**Practice Problem #1**

Journalize the following transactions.

- March 15 Purchased merchandise on account from Terrier Co., \$33,000, terms n/30.
- April 14 issued a 30-day, 8% note for \$33,000 to Terrier Co. on account
- May 14 Paid Terrier Co. the amount due on the note of April 14.
- June 15 Borrowed \$90,000 from Midland Bank, issuing a series of ten 12% notes for \$9,000 each, coming due at 30-day intervals.
- July 7 Purchased merchandise by issuing a \$72,000, 60-day note to Petco Company, which discounted the note at the rate of 9%.

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- July 16 Paid the amount due to Midland Bank on the first note in the series issued on June 15.
- Aug. 15 Paid the amount due to Midland Bank on the second note in the series issued on June 15.
- Sept. 5 Paid Petco Company the amount due on the note of July 7.
- Dec. 31 Accrued interest on the outstanding Notes Payable. There are currently four Notes Payable to Midland Bank outstanding.

## **ESTIMATED LIABILITIES**

Estimated liabilities have a known payee and a known payment date but an uncertain payment amount which can be reasonably estimated. The uncertainty for the amount may arise because the amount to be paid is based on a future event or another amount which has yet to be determined.

Examples of estimated liabilities include bonuses; vacation, health and pension benefits and warranty liabilities.

An estimated expense is recorded in the same period as the revenue and an estimated liability is recorded for the expected future goods/services to be provided. When payments are made or services provided in the future, the liability is reduced and the appropriate balance sheet account is credited. Note that an expense is not recorded when the warranty goods/services are provided.

### **Practice Problem #2**

Journalize the following transactions.

- December 31 Sales for the year were \$1,000,000. Cost of Goods Sold is 60% of sales. Expected warranty claims were estimated at 2% of sales. No warranty claims were reported during the year.
- March 31 The Howard Company reported that two units broke down while under warranty and \$12,500 was spent to repair the product. Sales for the quarter were \$200,000.
- May 15 Thomas Inc. reported that two units they purchased last year failed. Further inspection determined that the units had to be replaced at a cost of \$18,000.
- June 30 Sales for the quarter were \$300,000.

## CONTINGENT LIABILITIES

A contingent liability requires the same three elements to be present as a known liability in order to be recorded: a **PAST** event must have occurred which results in **PRESENT** obligation to pay a third party which will be paid at some **FUTURE** date. The difference between a contingent liability and a known liability is that a contingent liability is a potential liability, uncertain as to whether the future event will occur.

1. Contingent liabilities are recorded when the future event is probable and the amount is known or can be reasonably estimated.
2. Contingent liabilities are disclosed in the footnotes to the financial statements when the future event is probable and the amount is not known or cannot be reasonably estimated or when the future event is possible and the amount is not known or cannot be reasonably estimated.
3. Contingent liabilities are not recorded or disclosed when the future event is unlikely to occur.

## SAMPLE MULTIPLE CHOICE QUESTIONS

1. On June 5, Apex Co. issued a \$30,000, 8% 120-day note payable to Jones Co. Assume the fiscal of Apex Co. ends June 30. What is the amount of interest expense recognized by Apex in the current year?
  - a. \$166.67
  - b. \$800.00
  - c. \$333.33
  - d. \$633.34
  
2. On June 5, Apex Co. issued a \$30,000, 8% 120-day note payable to Jones Co. Assume the fiscal year of Jones Co. ends June 30. What is the amount of interest revenue recognized by Jones in the following year?
  - a. \$633.33
  - b. \$400.00
  - c. \$333.33
  - d. \$166.67
  
3. Proceeds of \$24,250 were received from discounting a \$25,000, 90-day, non-interest-bearing note at a bank. The discount rate used by the bank in computing the proceeds was:
  - a. 12%
  - b. 14%
  - c. 6%
  - d. 10%
  
4. The cost of a product warranty should be included as an expense in the:
  - a. Period the cash is collected for a product sold on account
  - b. Future period when the cost of repairing the product is paid
  - c. Future period when the product is repaired or replaced
  - d. Period of the sale of the product
  
5. Jergens Co. issued a \$17,500, 60-day, non-interest-bearing note to River City Bank. The discount rate is 9%. The cash proceeds to Jergens Co. is:
  - a. \$16,975.00
  - b. \$17,500.00
  - c. \$17,237.50
  - d. \$17,762.50

6. Which of the following is not a typical current liability?

- a. Sales Taxes Payable
- b. Mortgage Payable
- c. Unearned Revenue
- d. Interest Payable

7. On July 1, Tanner Co. borrowed \$70,000 from the City Bank for 150 days at 9%. The entry to record payment of the note on the due date would be:

- |    |                  |        |        |
|----|------------------|--------|--------|
| a. | Cash             | 72,625 |        |
|    | Notes Payable    |        | 70,000 |
|    | Interest Income  |        | 2,625  |
| b. | Notes Payable    | 72,625 |        |
|    | Cash             |        | 72,625 |
| c. | Notes Payable    | 70,000 |        |
|    | Interest Payable | 2,625  |        |
|    | Cash             |        | 72,625 |
| d. | Notes Payable    | 70,000 |        |
|    | Interest Expense | 2,625  |        |
|    | Cash             |        | 72,625 |

8. On March 5, Eaton Corporation issued a 90-day, non-interest-bearing note for \$5,000 to Roan, Inc. for merchandise purchased. Roan, Inc. discounted the note at 6%. The entry to record the issuance of the note would be:

- |    |                       |       |       |
|----|-----------------------|-------|-------|
| a. | Merchandise Inventory | 5,000 |       |
|    | Notes Payable         |       | 5,000 |
| b. | Merchandise Inventory | 4,700 |       |
|    | Notes Payable         |       | 4,700 |
| c. | Merchandise Inventory | 4,925 |       |
|    | Interest Expense      | 75    |       |
|    | Notes Payable         |       | 5,000 |
| d. | Merchandise Inventory | 4,925 |       |
|    | Notes Payable         |       | 4,925 |

9. The entry to record the payment of a \$12,000, 8%, 60-day note at maturity would include a debit to:

- a. Cash for \$12,160
- b. Notes Payable for \$12,160
- c. Interest Income for \$160
- d. Interest Expense for \$160

The Land Company manufactures motorcycle helmets. The company is the defendant in a lawsuit which it is certain will result in a settlement of \$500,000 against the company. Three other lawsuits have been filed with total damages exceeding \$1,000,000. The company is concerned about rumors that other lawsuits may be filed in the future.

10. Land should record expense in the amount of:

- a. \$500,000
- b. \$1,000,000
- c. \$1,500,000
- d. Some other amount

11. Land should disclose:

- a. One lawsuit with \$500,000 of damages
- b. Three lawsuits with damages exceeding \$1,000,000
- c. Four lawsuits with damages exceeding \$1,500,000
- d. All lawsuits whether filed or rumored

## SOLUTIONS TO PRACTICE PROBLEMS

**Practice Problem #1**

3/15	Mdse Inventory	33,000	
	A/P		33,000
4/14	A/P	33,000	
	Notes Payable		33,000
5/14	Interest:	$33,000 * .08 * 30/360 = 220$	
	Notes Payable	33,000	
	Interest Expense	220	
	Cash		33,220
6/15	Cash	90,000	
	Notes Payable		90,000
7/07	Discount:	$72,000 * .09 * 60/360 = 1,080$ ; Proceeds: $72,000 - 1,080 = 70,920$	
	Merchandise Inventory	70,920	
	Interest Expense	1,080	
	Notes Payable		72,000
7/16	Interest Due:	$9,000 * .12 * 30/360 = 90$	
	Notes Payable	9,000	
	Interest Expense	90	
	Cash		9,090
8/15	Interest Due:	$9,000 * .12 * 60/360 = 180$	
	Notes Payable	9,000	
	Interest Expense	180	
	Cash		9,180
9/05	Notes Payable	72,000	
	Cash		72,000
12/31	Notes:	4 notes @ 9,000 each = \$36,000; Interest: $36,000 * .12 * 199/360 = 2,388$	
	Interest Expense	2,388	
	Interest Payable		2,388

**Practice Problem #2**

December 31	Cash	1,000,000	
	Sales		1,000,000
	COGS	600,000	
	Merchandise Inventory		600,000
	Warranty Expense	20,000	
	Estimated Warranty Liability		20,000
March 31	Estimated Warranty Liability	12,500	
	Repair Parts Inventory		12,500
	Cash	200,000	
	Sales		200,000
	COGS	120,000	
	MI		120,000
	Warranty Expense	4,000	
	Estimated Warranty Liability		4,000
May 15	Estimated Warranty Liability	18,000	
	Merchandise Inventory		18,000
June 30	Cash	300,000	
	Sales		300,000
	COGS	180,000	
	MI		180,000
	Warranty Expense	6,000	
	Estimated Warranty Liability		6,000

## SOLUTIONS TO MULTIPLE CHOICE QUESTIONS

1. A:  $30,000 * .08 * 25/360 = \$166.67$   
2. B:  $30,000 * .08 * 95/360 = \$633.33$   
3. A:  $25,000 * X * 90/360 = (25,000 - 24,250)$   
 $6,250X = 1,750$   
 $X = 12\%$

4. D  
5. C: Discount:  $17,500 * .09 * 60/360 = 262.50$   
Proceeds:  $17,500 - 262.50 = 17,237.50$   
6. B  
7. D: Interest:  $70,000 * .09 * 150/360 = \$2,625$   
8. C: Discount:  $5,000 * .06 * 90/360 = 75$   
Proceeds:  $5,000 - 75 = 4,925$   
9. D: Interest:  $12,000 * .08 * 60/360 = 160$

Notes Payable	12,000	
Interest Expense	160	
Cash		12,160

10. A  
11. B