Financial Accounting

Sixth Edition

Current Liabilities

CHAPTER 8

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PART A

CURRENT LIABILITIES

Learning Objective 1

LO8–1 Distinguish between current and long-term liabilities.

Liabilities

- A **liability** is an obligation of a company to transfer some economic benefit in the future.
- Most liabilities require the payment of cash in the future.
  - Accounts payable
  - Notes payable
  - Salaries payable
- Other liabilities, such as deferred revenue, arise when a company receives cash in advance from customers.
  - These liabilities represent an obligation of the company to transfer inventory or services to those customers in the future.

Current vs. Long-Term Liabilities

Current	Long-Term
• Usually payable **within one year** from the balance sheet date	• Payable **in more than one year** from the balance sheet date

Operating cycle: An operating cycle is the length of time from spending cash to provide goods and services to a customer until collection of cash from that customer. If a company has an operating cycle longer than one year (a winery, for example), its current liabilities are defined by the operating cycle rather than by the length of a year.

A company with a 3-month operating cycle would classify current liabilities as those due within one year.

A company with a 15-month operating cycle would classify current liabilities as those due within 15 months.

Illustration 8–1

Risk Factors of United Airlines

UNITED AIRLINES
Management Discussion and Analysis (excerpt)

The global pandemic resulting from a novel strain of coronavirus has had an adverse impact that has been material to the Company's business, operating results, financial condition, and liquidity, and the duration and spread of the pandemic could result in additional adverse impacts. The outbreak of another disease or similar public health threat in the future could also have an adverse effect on the Company's business, operating results, financial condition, and liquidity.

The Company has a significant amount of financial leverage from fixed obligations and intends to seek material amounts of additional financial liquidity in the short-term, and insufficient liquidity may have a material adverse effect on the Company's financial condition and business.

Illustration 8–2

Current Liabilities Section for Southwest Airlines

SOUTHWEST AIRLINES Balance Sheet (partial) ($ in millions)	
Current liabilities:	
Accounts payable	$1,574
Accrued liabilities	1,749
Current operating lease liabilities	353
Air traffic liability	4,457
Current maturities of long-term debt	819
Total current liabilities	$8,952

Concept Check 8–1

Which of the following is typically considered a current liability?

a. Salaries payable

b. Prepaid insurance

c. Mortgage payable due in 30 years

d. Accounts receivable

Current liabilities are payable within one year. Salaries payable are generally paid in less than a year. Prepaid insurance and accounts receivable are assets, and the mortgage payable due in 30 years is a long-term liability.

Key Point

In most cases, current liabilities are payable within one year from the balance sheet date, and long-term liabilities are payable in more than one year.

Learning Objective 2

LO8–2 Account for notes payable and interest expense.

Notes Payable

- Note signed by a firm promising to repay the amount borrowed **plus interest**
- Interest on notes is calculated as:

$$\text{Interest} = \text{Face value} \times \text{Annual interest rate} \times \text{Fraction of the year}$$

Recording Notes Payable

- Southwest Airlines borrows $100,000 from Bank of America on September 1, 2024, signing a 6%, six-month note for the amount borrowed plus accrued interest due six months later on March 1, 2025.
- On September 1, 2024, Southwest will receive $100,000 in cash and record the following:

September 1, 2024	Debit	Credit
Cash	**100,000**	
Notes Payable		**100,000**
(Issue notes payable)		

Recording Interest Payable

- Interest incurred for the six-month period of the note equals: **$100,000 x 6% x 6/12 = $3,000**.
- Southwest's reporting period ends on December 31. As such, the company reports the four months' interest incurred during 2024 in its 2024 financial statements.
- Interest incurred for that four-month period is: **$100,000 x 6% x 4/12 = $2,000**.
- The adjusting entry to record interest is:

December 31, 2024	Debit	Credit
Sept. 1 to Dec. 31		
Interest Expense (= $100,000 × 6% × 4/12) ...	**2,000**	
Interest Payable		**2,000**
(Record interest incurred, but not paid)		

Common Mistake

When calculating the number of months of interest, students sometimes mistakenly Subtract December (month 12) from September (month 9) and get three months.

However, the time from September 1 to December 31 includes both September and December, so there are four months.

Recording Repayment of Notes Payable

- When the note comes due on March 1, 2025, Southwest Airlines will pay the face value of the loan ($100,000) plus the entire $3,000 interest incurred ($100,000 × 6% × 6/12).
- Interest incurred during 2025 (January and February) equals: **$100,000 x 6% x 2/12 = $1,000**.
- The entry to record repayment of the note and interest is:

March 1, 2025	Debit	Credit
Notes Payable (face value)............................	**100,000**	
Interest Expense (= $100,000 × 6% × 2/12) ...	**1,000**	
Interest Payable (= $100,000 × 6% × 4/12)	**2,000**	
Cash...		**103,000**
(Pay notes payable and interest)		

Jan. 1 to Mar. 1, 2025

Sept. 1 to Dec. 31, 2024

Key Point

We record interest expense in the period in which we ***incur*** it, rather than in the period in which we **pay** it.

Concept Check 8–2

On October 1, a company signs a $10,000, 5%, 6-month note payable. How much interest would be recorded by December 31 of the same year?

a. $250
b. $125
c. $500
d. $0

Interest is recorded for the period from the date of the signing of the note (10/1) to the end of the fiscal year (12/31). The amount recorded for three months is:

Interest = $10,000 × 5% × 3/12 = $125

Line of Credit & Commercial Paper

- **Line of credit**:
  - Informal agreement
  - Permits a company to borrow up to a prearranged limit
  - Recorded similar to notes payable
- **Commercial paper**:
  - Borrowing from another company rather than a bank
  - Sold with maturities ranging from 30 to 270 days
  - Interest rate is usually lower than on a bank loan

Key Point

Many short-term loans are arranged under an existing line of credit with a bank, or for larger corporations in the form of commercial paper, a loan from one company to another.

Accounts Payable

- Amounts owed to suppliers of merchandise or services
- Sometimes called trade accounts payable
- Most accounts payable are current liabilities, but they could be long-term liabilities, depending on the due date.

Learning Objective 3

LO8–3 Account for employee and employer payroll liabilities.

Illustration 8–3

Payroll Costs for Employees and Employers

Employee Costs	Employer Costs
• Federal and state income taxes	• Federal and state unemployment taxes
• Employee portion of Social Security and Medicare (FICA taxes)	• Employer matching portion of Social Security and Medicare
• Employee contributions for health, dental, disability, and life insurance	• Employer contributions for health, dental, disability, and life insurance
• Employee investments in retirement or savings plans	• Employer contributions to retirement or savings plans

Employee Costs

- Federal and state income taxes
- FICA taxes
  - 7.65% (6.2% Social Security tax up to a maximum base amount + 1.45% Medicare tax with no maximum)
  - Collectively, Social Security and Medicare taxes
- Employees may have additional amounts withheld from their paychecks for health, dental, disability, and life insurance
- Employees may also have amounts deducted for retirement or employee savings plans

Employer Costs

- Additional (matching) FICA tax on behalf of the employee
- Employers also pay federal and state **unemployment taxes** on behalf of employees
  - FUTA and SUTA
- **Fringe benefits**: Additional employee benefits paid for by the employer
  - Health, dental, disability, and life insurance
  - Contributions to retirement or savings plans

Common Mistake

- Many people think FICA taxes are paid only by the employee.
- The employer is required to match the amount withheld for each employee, effectively doubling the amount paid into Social Security.

Illustration 8–4

Payroll Example, Hawaiian Travel Agency

- Hawaiian Travel Agency has a total payroll for the month of January of $100,000 for its 20 employees.

Federal and state income tax withheld	$24,000
FICA tax rate (Social Security and Medicare)	7.65%
Health insurance premiums (Blue Cross) paid by employer	$5,000
Contribution to retirement plan (Fidelity) paid by employer	$10,000
Federal and state unemployment tax rate	6.2%

- Hawaiian Travel records *employee* salary expense, withholdings, and salaries payable on January 31 as follows:

January 31	Debit	Credit
Salaries Expense	**100,000**	
Employee Income Tax Payable		**24,000**
FICA Tax Payable (= 0.0765 × $100,000)		**7,650**
Salaries Payable (to employees)		**68,350**
(Record employee salary expense and withholdings)		

Recording Employer-Provided Fringe Benefits

Federal and state income tax withheld	$24,000
FICA tax rate (Social Security and Medicare)	7.65%
Health insurance premiums (Blue Cross) paid by employer	$5,000
Contribution to retirement plan (Fidelity) paid by employer	$10,000
Federal and state unemployment tax rate	6.2%

- Hawaiian Travel Agency also records its employer-provided fringe benefits as Salaries Expense and records the related credit balances to Fringe Benefits Payable:

January 31	Debit	Credit
Salaries Expense (fringe benefits)	**15,000**	
Fringe Benefits Payable (to Blue Cross)......		**5,000**
Fringe Benefits Payable (to Fidelity)...........		**10,000**
(Record employer-provided fringe benefits)		

Recording Employer Payroll Taxes

Federal and state income tax withheld	$24,000
FICA tax rate (Social Security and Medicare)	7.65%
Health insurance premiums (Blue Cross) paid by employer	$5,000
Contribution to retirement plan (Fidelity) paid by employer	$10,000
Federal and state unemployment tax rate	6.2%

- Hawaiian Travel Agency pays employer's FICA taxes at the same rate that the employees pay (7.65%) and also pays unemployment taxes at the rate of 6.2%.
- The agency records its employer's payroll taxes as follows:

December 31	Debit	Credit
Payroll Tax Expense (total)	**13,850**	
FICA Tax Payable (= 0.0765 × $100,000)		**7,650**
Unemployment Tax Payable (= 0.062 × $100,000)		**6,200**
(Record employer payroll taxes)		

Key Point

- Employee salaries are reduced by withholdings for federal and state income taxes, FICA taxes, and the employee portion of insurance and retirement contributions.
- The employer, too, incurs additional payroll expenses for unemployment taxes, the employer portion of FICA taxes, and employer insurance and retirement contributions.

Concept Check 8–3

Which of the following items is typically paid by the employer only?

a. Federal and state income taxes on employees' wages

b. Social Security taxes

c. Federal and state unemployment taxes

d. Medicare taxes

Companies are required by law to withhold federal and state income taxes from employees' paychecks. Employers are also required to withhold Social Security and Medicare taxes from employees' paychecks. In addition, employers may withhold optional deductions, such as medical insurance premiums, contributions to retirement programs, and other fringe benefits. Unemployment taxes are NOT withheld, because they are paid solely by the employer.

Learning Objective 4

LO8–4 Explain the accounting for other current liabilities.

Other Current Liabilities

- **Deferred revenue**
  - Cash received in advance from a customer for products or services to be provided in the future
- **Sales tax payable**
  - Sales tax collected from customers by the seller, representing current liabilities payable to the government
- **Current portion of long-term debt**
  - Debt that will be paid within one year from the balance sheet date

Illustration 8–5
Revenue Recognition Policy of United Airlines

UNITED AIRLINES
Notes to the Financial Statements (excerpt)

The Company presents Passenger revenue, Cargo revenue, and Other operating revenue on its income statement. **Passenger revenue is recognized when transportation is provided**, and Cargo revenue is recognized when shipments arrive at their destination. Other operating revenue is recognized as the related performance obligations are satisfied**.**

Deferred Revenues

- Assume Apple Inc. sells an iTunes gift card to a customer for $100.
- Apple records the sale of the gift card as follows:

	Debit	Credit
Cash	**100**	
Deferred Revenue		**100**
(Receive cash for gift card)		

- When the customer purchases and downloads, say, $15 worth of music, Apple records the following:

	Debit	Credit
Deferred Revenue	**15**	
Sales Revenue		**15**
(Record revenue for music downloaded)		

Common Mistake

- Some students incorrectly think the Deferred Revenue account is a revenue account, since the account has the word “Revenue” in the title.
- As indicated above, Deferred Revenue is a liability account, not a revenue account.

Sales Tax Payable

Suppose you buy lunch in the airport for $15 plus 10% sales tax. The airport restaurant records the transaction this way:

	Debit	Credit
Cash	**16.50**	
Sales Revenue		**15.00**
Sales Tax Payable (= $15 × 10%)...		**1.50**
(Record sales and sales tax)		

The sales tax can be computed by knowing the total cash for the transaction and the sales tax rate:

$$\text{Sales tax} = \text{Total cash paid} - \frac{\text{Total cash paid}}{1 + \text{Sales tax rate}}$$

Key Point

- Sales taxes collected from customers by the seller are not an expense.
- Instead, they represent current liabilities payable to the government.

Current Portion of Long-Term Debt

- The current portion of long-term debt is the amount that will be paid within one year from the balance sheet date.
- Management needs to know this amount in order to budget the cash flow necessary to pay the current portion as it comes due.

Example

Current Portion of Long-Term Debt

- Suppose a company has a long-term note payable of $1,000,000. At the balance sheet date, the company determines that $200,000 of the note is due within the next 12 months (2025), while the remaining $800,000 is due in later periods (2026 and beyond).
- The company needs to reclassify $200,000 of the long-term note to current notes payable.

December 31, 2024	Debit	Credit
Notes Payable (long-term)………………..	**200,000**	
Notes Payable (short-term)……….		**200,000**
(Reclassify long-term portion of notes as current)		

Illustration 8–6

Current Portion of Long-Term Debt

SOUTHWEST AIRLINES **Balance Sheet (partial)** ($ in millions)	
Current liabilities:	
Current maturities of long-term debt	$ 566
Long-term liabilities:	
Long-term debt less current maturities	2,821
Total borrowings	$3,387

Key Point

We report the currently maturing portion of a long-term debt as a current liability in the balance sheet.

Concept Check 8–5

A home improvement store sells some merchandise to a customer. The price of the merchandise is $200 and the sales tax rate is 6.5%. How much would be recorded in the sales tax payable account?

a. $13.00
b. $213.00
c. $130.00
d. None of the above

Sales tax payable at the time of the sale would be computed as the price of the merchandise multiplied by the sales tax rate. In this case:
$\$200 \times 0.065 \text{ (or } 6.5\%) = \$13.00$

PART B

CONTINGENCIES

Learning Objective 5

LO8–5 Apply the appropriate accounting treatment for contingencies.

Contingent Liabilities

- Contingencies
  - Uncertain situations that can result in a gain or a loss for a company
- Contingent liability
  - An existing uncertain situation that might result in a loss

Illustration 8–7

Criteria for Reporting a Contingent Liability

1. The likelihood of payment is

a. Probable—likely to occur;

b. Reasonably possible—more than remote but less than probable; or

c. Remote—the chance is slight.

2. The amount of payment is

a. Reasonably estimable; or

b. Not reasonably estimable.

A contingent liability is recorded only if a loss is probable and the amount is reasonably estimable.

Illustration 8–7

Accounting Treatment of Contingent Liabilities

Likelihood of payment is:	Amount of payment is: Reasonably Estimable	Amount of payment is: Not Reasonably Estimable
Probable	Liability recorded	Disclosure required
Reasonably possible	Disclosure not required	Disclosure not required
Remote	Disclosure required	Disclosure required

If it is probable that Jeeps, Inc., will lose a $100 million lawsuit at some point in the future, Jeeps records the following entry:

December 31	Debit	Credit
Loss..	**100,000**	
Contingent Liability		**100,000**
(Record a contingent liability)		

Illustration 8–9

Disclosure of Contingencies by United Airlines

UNITED AIRLINES

Notes to the Financial Statements (excerpt)

Legal and Environmental Contingencies. The Company has certain contingencies resulting from litigation and claims incident to the ordinary course of business. Management believes, after considering a number of factors, including (but not limited to) the information currently available, the views of legal counsel, the nature of contingencies to which the Company is subject and prior experience, that the ultimate disposition of the litigation and claims will not materially affect the Company's consolidated financial position or results of operations. The Company records liabilities for legal and environmental claims when a loss is probable and reasonably estimable. These amounts are recorded based on the Company's assessments of the likelihood of their eventual disposition.

Warranties

- Most common example of contingent liabilities
- A warranty for a product represents a liability for a company at the time of the sale if it meets the criteria for recording a contingent liability:
  1. Probable, ***and***
  2. Reasonably estimable
- Even if the company doesn't know precisely what the warranty costs will be next year, it can formulate a reasonable prediction from:
  - Past experiences
  - Industry statistics
  - Other current business conditions

Accounting for Warranties

- Assume warranty costs are estimated to be 3% of sales. December 2024 sales are \$1.5 million. The following adjusting entry is recorded:

December 31, 2024	Debit	Credit
Warranty Expense..	**45,000**	
Warranty Liability		**45,000**
(Record liability for warranties) (\$45,000 = \$1.5 million × 3%)		

- Warranty claims totaling \$12,000 are made during January, 2025. The following entry is recorded:

January 31, 2025	Debit	Credit
Warranty Liability......................................	**12,000**	
Cash		**12,000**
(Record actual warranty expenditures)		

	Warranty Liability (Debit)	Warranty Liability (Credit)	
		45,000	Estimated expense
Actual payment	12,000		
		33,000	Current balance

Concept Check 8–6

Which of the following statements is true with respect to warranty liabilities?

a. Warranty expense needs to be recorded in the period the warranty repair is made.

b. The warranty expense account balance will always equal the warranty liability account balance.

c. The warranty liability account is debited as actual repairs are made.

d. All of the above are true.

The warranty expense needs to be recorded in the same accounting period that ***the sale is made***. The warranty expense account is ***rarely*** equal to the warranty liability account. The warranty liability is increased when the estimated liability is recorded and reduced over time (by a debit) for the actual warranty expenditures.

Concept Check 8–7

During its first year of business, Oceanic, Inc. has sales of $300,000 and pays warranty claims of $10,400. Oceanic offers a one-year warranty and anticipates that warranty costs will total 5% of sales. What is the balance in Oceanic's Warranty Liability account at the end of the first year?

a. $15,000
b. $4,600
c. $25,400
d. $20,800

The estimated amount of total warranty expense is $300,000 × 5% = $15,000. Since payments of $10,400 were made during the year, the remaining warranty costs estimated to occur next year is: $15,000 – $10,400 = $4,600. The Warranty Liability account will have a balance of $4,600 at the end of the first year.

Common Mistake

- Some students think the balance in the Warranty Liability account is always equal to Warranty Expense.
- Remember, the Warranty Liability account is increased when the estimated warranty liability is recorded, but then is reduced over time by actual warranty expenditures.

Contingent Gains

- An existing uncertain situation that might result in a gain
  - In a lawsuit, one side–the defendant faces a contingent liability, while the other side—the plaintiff—has a contingent gain
- Not recorded until the gain is known with certainty

Key Point

Unlike contingent liabilities, contingent gains are not recorded until the gain is certain and no longer a contingency.

ANALYSIS

LIQUIDITY ANALYSIS

Learning Objective 6

LO8–6 Assess liquidity using current liability ratios.

Liquidity Analysis

- **Liquidity**: refers to having sufficient cash or other current assets to pay currently maturing debts
- Lack of liquidity can result in financial difficulties or even bankruptcy
- Three liquidity measures:
  - **Working capital**
  - **Current ratio**
  - **Acid-test ratio**

Working Capital

Working capital = Current assets – Current liabilities

- Measure of current assets remaining after paying current liabilities
- A large positive working capital is an indicator of liquidity—whether a company will be able to pay its current obligations on time
- Not the best measure of liquidity for comparing one company with another

Current Ratio

$$\textbf{Current Ratio} = \frac{\textbf{Current assets}}{\textbf{Current liabilities}}$$

- The amount of current assets available for every $1 of current liabilities
- The higher the current ratio, the greater the company's liquidity
- A current ratio of, say, 1.5 indicates that for every dollar of current liabilities, the company has $1.50 of current assets

Acid-Test Ratio

- The amount of "quick assets" available for every $1 of current liabilities
- **Quick assets**
  - Include only cash, current investments, and accounts receivable
  - Exclude other current assets, such as inventory and prepaid rent
- May provide a better overall indication of a company's liquidity

$$\textbf{Acid-test ratio} = \frac{\textbf{Cash + Current investments + Accounts receivable}}{\textbf{Current liabilities}}$$

Key Point

- Working capital is the difference between current assets and current liabilities.
- The current ratio is equal to current assets divided by current liabilities.
- The acid-test ratio is equal to quick assets (cash, current investments, and accounts receivable) divided by current liabilities.
- Each measures a company’s liquidity, its ability to pay currently maturing debts.

Common Mistake

- As a general rule, a higher current ratio is better.
  - However, a high current ratio is not always a positive signal.
  - Companies having difficulty collecting receivables or holding excessive inventory will also have a higher current ratio.
- Managers must balance the incentive for strong liquidity (yielding a higher current ratio) with the need to minimize levels of receivables and inventory (yielding a lower current ratio).

Concept Check 8–8

The current ratio is:

a. Computed as the difference between current assets and current liabilities

b. Computed as current assets divided by current liabilities

c. A measure of profitability

d. All of the above

The current ratio is calculated by dividing current assets by current liabilities. It is a measure of liquidity (rather than profitability).

Illustration 8–10

Effect of Various Changes on the Liquidity Ratios

	Changes that Increase the Ratio	Changes that Decrease the Ratio
Current Ratio	• Increase in current assets	• Decrease in current assets
	• Decrease in current liabilities	• Increase in current liabilities
Acid-Test Ratio	• Increase in quick assets	• Decrease in quick assets
	• Decrease in current liabilities	• Increase in current liabilities

Liquidity Management

- Management can influence the ratios that measure liquidity to some extent.
- Examples:
    - Delay the shipment and billing of certain inventory parts to receive them in early January rather than late December, reducing inventory and accounts payable at year-end.
    - Make additional purchases in late December, increasing inventory and accounts payable at year-end.

Liquidity Management Example #1

Current Ratio Currently > 1

- Current Ratio = \$5 million/\$4 million = **1.25**. However, debt covenant requires minimum current ratio greater than **1.25**.
- Impact of receipt of \$1 million of goods that is delayed until early January:
    - Inventory and accounts payable both lower by \$1 million
    - Current ratio = \$4 million/\$3 million) = **1.33**. Debt covenant requirement is met.

Liquidity Management Example #2

Starting Current Ratio Currently < 1

- Current Ratio = $3 million/$4 million = **0.75**. However, debt covenant requires minimum current ratio > 0.75.
- Impact of receipt of $1 million of goods that is delayed until early January:
  - Inventory and accounts payable both lower by $1 million
  - Current ratio = $2 million/$3 million) = 0.67. **Debt covenant requirement is not met.**
- Impact of purchase $1 million in additional inventory on credit:
  - Inventory and accounts payable both higher by $1 million
  - Current ratio = $4 million/$5 million) = 0.80. **Debt covenant requirement is met.**

End of Chapter 8