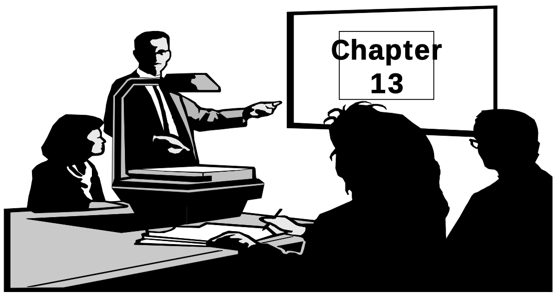
CURRENT LIABILITIES & CONTINGENCIES



ECON 136A REFRESHER

What is a liability?

- Present (not necessarily current) unavoidable obligation;
- Result of a past transaction;

What makes a liability current?

- Conversion in one year or operating cycle, whichever is longer
- Current liabilities are not recorded at their present value as they "turn" soon enough that there is no material difference.

07:35

136A Concepts

- Purchase discounts on A/P has already been covered, refresher is in text. You can also look at:

GROSS METHOD			NET METHOD		
Purchase Cost $10,000 terms 2/10 net 30					
Purchases	10,000		Purchases	9,800	
Accounts Payable		10,000	Accounts payable		9,800
Invoices of $4,000 paid within discount period					
Accounts payable	4,000		Accounts payable	3,920	
Purchase discount		80	Cash		3,920
Cash		3,920			
Invoices of $6,000 paid after discount period					
Accounts payable	6,000		Accounts payable	5,880	
Cash		6,000	Purchase discounts lost	120	
			Cash		6,000

Notes Payable

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

Example --

On April 1, the corporation bought a truck for $30,000 from GM Company, paying $4,000 in cash and signing a one-year, 12% note for the balance of the purchase price.

Notes Payable

April 1 Journal Entry ?	Debit	Credit
Trucks	30,000	
Cash		4,000
Notes payable		26,000

Any entry required at April 30 ?

Interest expense	260	
Interest payable		260

($26,000 x 12% / 12)

Zero Interest-bearing Note

Written promises to pay a certain sum of money on a specified future date. No such thing as 0% interest, always "impute a rate" if the stated rate is different than a reasonable rate.

Example --

On May 1, the corporation borrowed $80,000 from Lima National Bank by signing a $90,200 non-interest bearing note due in one year.

07:35

Zero Interest-bearing Note

May 1 Journal Entry ?	Debit	Credit
Cash	80,000	
Discount on N/P	10,200	
Notes payable		90,200

Any entry required at May 30 ?

Interest expense	850	
Discount on N/P		850

($10,200 / 12 = $850)

Straight-line amortization is only acceptable if the results are not materially different from the effective interest method.

Current Maturities of Long-term Debt

The portion of bonds, mortgage notes, and other long-term indebtedness that matures with the next fiscal year.

Classification of Current Obligation to be Refinanced

It is possible that a "current" obligation may be classified as long-term IF:

1. Management intends to refinance

AND

2. Management can demonstrate the ABILITY to do so
   - Evidenced by commitment from lender or other party, OR
   - Subsequent refinance before the financial statements are issued (like a change in estimate)

Short-Term Obligations

07:35

Short-Term Obligations

Mgmt. Intends of Refinance

NO

YES

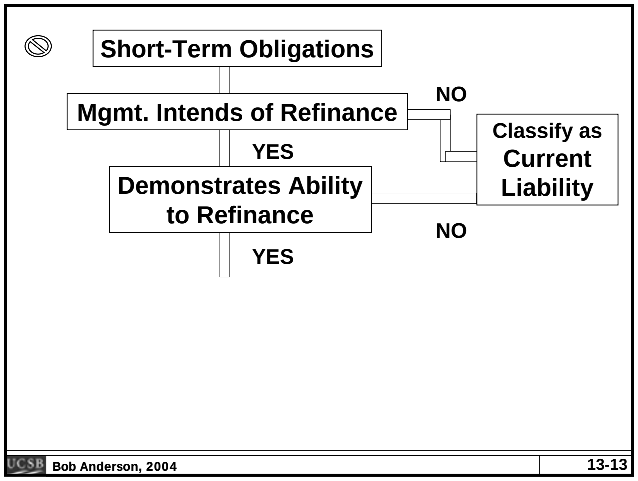
Short-Term Obligations

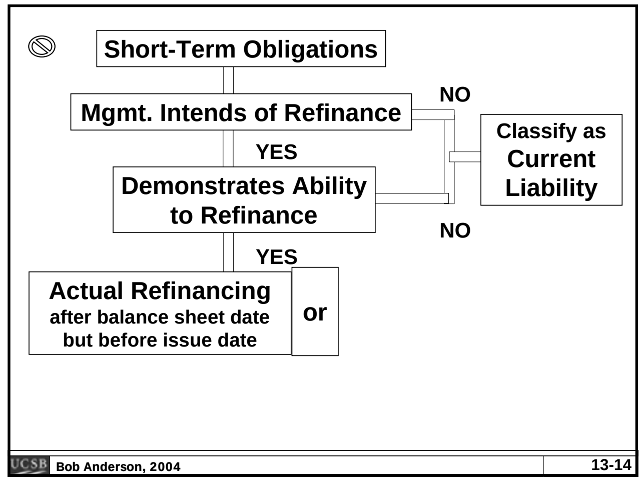
Mgmt. Intends of Refinance

NO

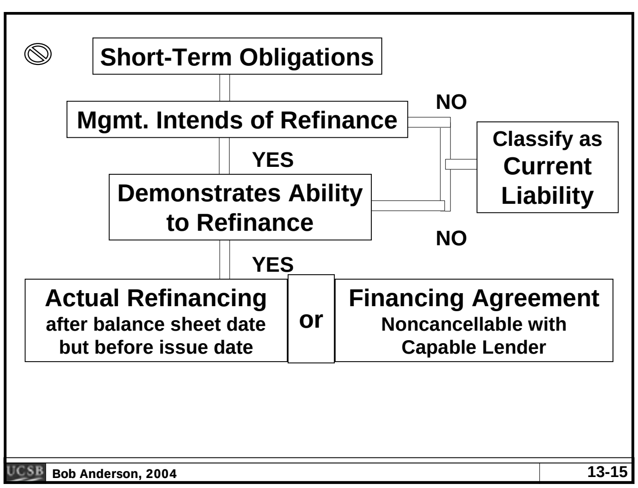
Classify as Current Liability

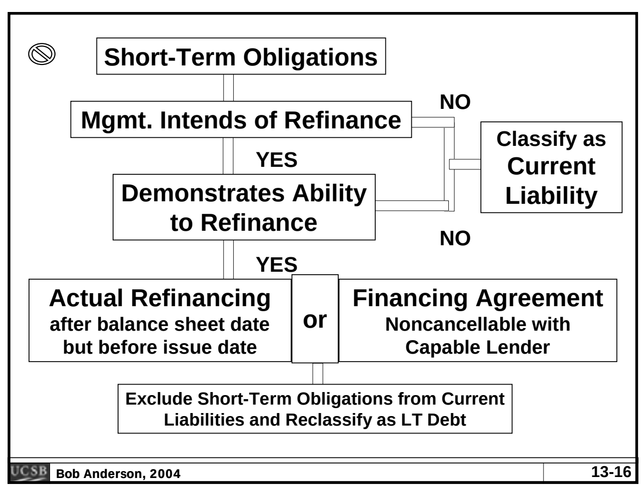
YES


Short-Term Obligations
Mgmt. Intends of Refinance
NO
Classify as Current Liability
YES
Demonstrates Ability to Refinance
NO
YES
Bob Anderson, 2004
13-13


Short-Term Obligations
Mgmt. Intends of Refinance
NO
Classify as Current Liability
YES
Demonstrates Ability to Refinance
NO
YES
Actual Refinancing
after balance sheet date
but before issue date
or
Bob Anderson, 2004
13-14

07:35


Short-Term Obligations
Mgmt. Intends of Refinance
NO
Classify as Current Liability
YES
Demonstrates Ability to Refinance
NO
YES
Actual Refinancing
after balance sheet date
but before issue date
or
Financing Agreement
Noncancellable with
Capable Lender
Bob Anderson, 2004
13-15


Short-Term Obligations
Mgmt. Intends of Refinance
NO
Classify as Current Liability
YES
Demonstrates Ability to Refinance
NO
YES
Actual Refinancing
after balance sheet date
but before issue date
or
Financing Agreement
Noncancellable with
Capable Lender
Exclude Short-Term Obligations from Current Liabilities and Reclassify as LT Debt
Bob Anderson, 2004
13-16

Example

(Refinancing of Short-Term Debt)

On December 31, 2001, Hattie McDaniel Company had $1,200,000 of short-term debt in the form of notes payable due February 2, 2002. On January 21, 2002, 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, 2002, the proceeds from the stock sale, supplemented by an additional $250,000 cash, are used to liquidate the $1,200,000 debt.

Example

Partial Balance Sheet

Current liabilities:	
Notes payable	250,000
Long-term debt:	
Notes payable refinanced	950,000
Total liabilities	1,200,000

07:35

Other Current Liabilities

Dividends payable --
- **current liability if cash or property**
- **equity if stock**

Unearned revenues
Sales taxes payable
Property taxes payable
Income taxes payable
Payroll taxes
Compensated absences
Postretirement benefits (chapter 21)
Bonus agreements

Case 13-1

(Nature of Liabilities) Presented below is the current liabilities section of Nizami Corporation.

	($000) 2000	1999
Current liabilities	$ 68,713	$ 7,700
Notes payable	179,496	101,379
Accounts payable	60,312	31,649
Compensation to employees	158,198	77,621
Accrued liabilities	10,486	26,491
Current maturities of long-term debt	16,592	6,649
Total current liabilities	$493,797	$251,489

Instructions: Answer the following questions.

Case 13-1

(a) What are the essential characteristics that make an item a liability?

(b) How does one distinguish between a current liability and a long-term liability?

(c) What are accrued liabilities? Give three examples of accrued liabilities that Nizami might have.

(d) What is the theoretically correct way to value liabilities? How are current liabilities usually valued?

(e) Why are notes payable reported first in the current liability section?

(f) What might be the items that comprise Nizami's liability for "Compensation to employees"?

Case 13-2

(Current versus Non-current Classification) D'Annunzio Corporation includes the following items in its liabilities at December 31, 2001:

1. Notes payable, $25,000,000, due June 30, 2002.
2. Deposits from customers on equipment ordered by them from D'Annunzio,
3. Salaries payable, $3,750,000, due January 14, 2002.

Instructions: Indicate in what circumstances, if any, each of the three liabilities above would be excluded from current liabilities.

07:35

Exercise

BE 13-5 Game Pro Magazine sold 10,000 annual subscriptions on August 1, 2001, for $12 each. Prepare Game Pro's August 1, 2001, journal entry and the December 31, 2001, annual adjusting entry.

Journal entry:

	Debit	Credit
8/1/01		
Cash	120,000	
Unearned subscription revenue		120,000
12/31/01		
Unearned subscription revenue	50,000	
Subscription revenue		50,000

Exercise

BE 13-6 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.

	Debit	Credit
Accounts receivable	31,800	
Sales		30,000
Sales taxes payable		1,800

($30,000 x 6% = $1,800)

(b) Prepare the entry to record Flintstones' cash sales.

	Debit	Credit
Cash	19,610	
Sales		18,500
Sales taxes payable		1,110

($19,610 / 1.06 = $18,500)

Exercise

BE 13-8 Future Zone Corporation's weekly payroll of $23,000 included FICA taxes withheld of $1,426, federal taxes withheld of $2,990, state taxes withheld of $920, and insurance premiums withheld of $250. Prepare the journal entry to record Future Zone's payroll.

	Debit	Credit
Wage expense	23,000	
FICA taxes payable		1,426
Federal income tax payable		2,990
State income tax payable		920
Insurance premiums payable		250
Wages payable		17,414

Contingencies

Existing situation involving uncertainty as to possible gain or loss ...

to be resolved by the occurrence or nonoccurrence of a future event.

Gain Contingencies --

- **not recorded, EXCEPT:**
  - **If there is a loss covered by insurance, you can reduce the loss by the probable insurance recovery.**
- **Others may be disclosed only if probability of receipt is high.**

07:35

Loss Contingencies

ALL loss contingencies which "could have a material adverse impact on the financial position" of a Company MUST be disclosed.

A loss contingency which is material should be accrued as a liability if it is:

- Probable

AND

- Estimable
  - If only a range of estimated loss can be made, then the lower-end of the range is accrued as a loss and the possible exposure is disclosed
    - So if the estimated loss range is $0-$10 million then there would be no accrual, and the $10 million exposure would be disclosed.

BRIEF EXERCISE

BE 13-11 XYZ Inc. is involved in a lawsuit at December 31, 2001. Prepare the December 31 entry assuming (a) it is probable that XYZ will be liable for $700,000 as a result of this suit (b) it is not probable that XYZ will be liable for any payment as a result of this suit. (c') the estimated range of loss is $100,000 to $1,000,000.

Journal entry:		Debit	Credit
(a)	Lawsuit loss	700,000	
	Lawsuit liability		700,000
(b)	No entry		
('c)	Lawsuit loss	100,000	
	Lawsuit liability		100,000

Loss Contingencies

BE 13-13 Frantic Factory provides a 2-year warranty with one of its products which was first sold in 2001. 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 2001 sales. Prepare Frantic's journal entry to record the $70,000 expenditure, and the December 31 adjusting entry.

Journal entry:

	Debit	Credit
2001		
Warranty expense	70,000	
Cash		70,000
12/31/01		
Warranty expense	500,000	
Warranty liability		500,000

Guarantees

In November 2002, the FASB issued

FIN 45: Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others

It applies to all guarantees issued after December 31, 2002 and differs dramatically from previous guidance which treated "guarantees" like other loss contingencies as discussed in previous slides. It requires:

- Disclosure of all guarantees;
- Liability accrual based on a probability weighted-average approach (CON 7) applied by management.

REMEMBER, THIS IS ONLY FOR "GUARANTEES", does not impact other "loss contingencies" which are accounted for as just discussed on previous slides.

07:35

FIN 45 Example

Developer, Inc. entered into a joint venture to purchase land and construct an office building. The joint venture obtained a $15 million construction loan, which matures in one year from a bank and the bank required that Developer, Inc. unconditionally guarantee the loan.

Management believes that the probability of having to perform under this guarantee is remote. Under previous guidance (FAS 5), no accrual would be required. However, management, in accordance with the provisions of FIN 45, performs the following probability-weighted-average analysis:

FIN 45: Fair Value Computation

	Probability	**Payment Under Guarantee**	**Prob. Wtd Average**
Most probable	87.50%	$ -	$ -
Possible	7.00%	$ 750,000	$ 52,500.00
Reasonably possible	4.50%	$ 2,500,000	$ 112,500.00
Remote	1.00%	$ 15,000,000	$ 150,000.00
	100.00%		
Estimated fair value of contingency			$ 315,000.00

ACCOUNTING ENTRY:

	Debit	Credit
Investment in joint venture	315,000.00	
Accrued liability: guarantee		315,000.00

NOTE: If this guarantee were deemed to impair the investment in the joint venture, then the debit would be to expense. BUT NOT LIKELY- why would the Company enter the guarantee if it impaired the investment?

THE LOGICAL SLIDE

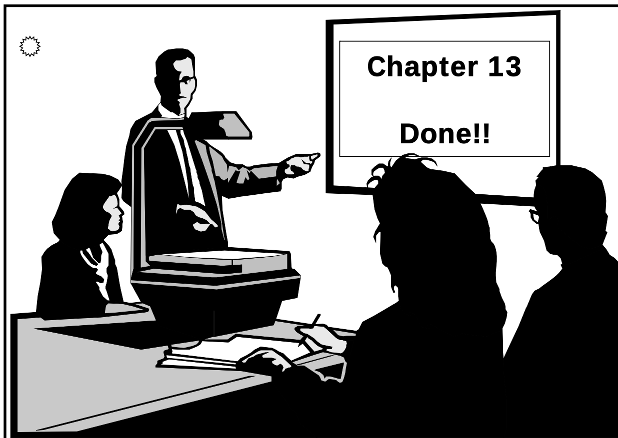
Who sang "The Logical Song"?

SUPERTRAMP

Here is an easy way to test for whether something is a liability yet:

- Did the Company receive the benefit yet?

If a company has a bonus plan that states that 10% of net income in excess of $2 million for the year is to be paid out in bonuses, and net income for the year is $2,500,000-is there a liability? How much? Why?



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