CURRENT LIABILITIES & CONTINGENCIES

Chapter 13

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.

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.

136A Concepts

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

<table>
<thead>
<tr>
<th>GROSS METHOD</th>
<th>NET METHOD</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchase Cost $10,000 terms 2/10 net 30</td>
<td></td>
</tr>
<tr>
<td>Purchases 10,000</td>
<td>Purchases 9,800</td>
</tr>
<tr>
<td>Accounts Payable 10,000</td>
<td>Accounts payable 9,800</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trucks</td>
<td>30,000</td>
</tr>
<tr>
<td>Cash</td>
<td>4,000</td>
</tr>
<tr>
<td>Notes payable</td>
<td>26,000</td>
</tr>
</tbody>
</table>

Any entry required at April 30?

- Interest expense: 260
- Interest payable: 260

($26,000 \times 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.

Current Maturities of Long-term Debt

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

Zero Interest-bearing Note

May 1 Journal Entry

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>80,000</td>
</tr>
<tr>
<td>Discount on N/P</td>
<td>10,200</td>
</tr>
<tr>
<td>Notes payable</td>
<td>90,200</td>
</tr>
</tbody>
</table>

Any entry required at May 30?

- Interest expense: 850
- Interest payable: 850

($10,200 / 12 = 850)

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

Mgmt. Intends of Refinance

- YES
  - Classify as Current Liability
- NO

07:35
Short-Term Obligations

- Mgmt. Intends of Refinance
  - YES
  - Demonstrates Ability to Refinance
    - YES
    - Classify as Current Liability
    - NO

- Actual Refinancing after balance sheet date but before issue date or Financing Agreement Noncancellable with Capable Lender
  - NO

Exclude Short-Term Obligations from Current Liabilities and Reclassify as LT Debt

- Mgmt. Intends of Refinance
  - YES
  - Demonstrates Ability to Refinance
    - YES
    - Classify as Current Liability
    - NO

- Actual Refinancing after balance sheet date but before issue date or Financing Agreement Noncancellable with Capable Lender
  - NO
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.

Additional Current Liabilities:
- Dividends payable
- Unearned revenues
- Sales taxes payable
- Property taxes payable
- Income taxes payable
- Payroll taxes
- Compensated absences
- Postretirement benefits (chapter 21)
- Bonus agreements

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

Presented below is the current liabilities section of Nizami Corporation. ($000)

<table>
<thead>
<tr>
<th></th>
<th>2000</th>
<th>1999</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current liabilities</td>
<td>$ 68,713</td>
<td>$ 7,700</td>
</tr>
<tr>
<td>Notes payable</td>
<td>179,496</td>
<td>101,379</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>60,312</td>
<td>31,649</td>
</tr>
<tr>
<td>Compensation to employees</td>
<td>158,198</td>
<td>77,621</td>
</tr>
<tr>
<td>Accrued liabilities</td>
<td>10,486</td>
<td>26,491</td>
</tr>
<tr>
<td>Current maturities of long-term debt</td>
<td>16,962</td>
<td>6,649</td>
</tr>
<tr>
<td>Total current liabilities</td>
<td>$493,797</td>
<td>$351,489</td>
</tr>
</tbody>
</table>

Instructions: Answer the following questions.
(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,

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

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:

8/1/01 Debit Credit
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.

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.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wage expense</td>
<td>23,000</td>
</tr>
<tr>
<td>FICA taxes payable</td>
<td>1,426</td>
</tr>
<tr>
<td>Federal income tax payable</td>
<td>2,990</td>
</tr>
<tr>
<td>State income tax payable</td>
<td>920</td>
</tr>
<tr>
<td>Insurance premiums payable</td>
<td>250</td>
</tr>
<tr>
<td>Wages payable</td>
<td>17,414</td>
</tr>
</tbody>
</table>

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:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Lawsuit loss</td>
<td>700,000</td>
</tr>
<tr>
<td>Lawsuit liability</td>
<td>700,000</td>
</tr>
<tr>
<td>(b) No entry</td>
<td></td>
</tr>
<tr>
<td>(c’) Lawsuit loss</td>
<td>100,000</td>
</tr>
<tr>
<td>Lawsuit liability</td>
<td>100,000</td>
</tr>
</tbody>
</table>
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:**

<table>
<thead>
<tr>
<th>2001</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Warranty expense</td>
<td>70,000</td>
<td>Cash</td>
</tr>
<tr>
<td></td>
<td>70,000</td>
<td></td>
</tr>
<tr>
<td>12/31/01</td>
<td>Warranty expense</td>
<td>500,000</td>
</tr>
<tr>
<td></td>
<td>Warranty liability</td>
<td>500,000</td>
</tr>
</tbody>
</table>

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.

**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:

<table>
<thead>
<tr>
<th>Probability</th>
<th>Payment Under Guarantee</th>
<th>Prob. Wtd Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Most probable</td>
<td>$750,000</td>
<td>$750,000</td>
</tr>
<tr>
<td>Remote</td>
<td>$15,000,000</td>
<td>$15,000,000</td>
</tr>
</tbody>
</table>

**FIN 45: Fair Value Computation**

**ACCOUNTING ENTRY:**

- 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 debt 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?