Current Liabilities

Key Topics to Know

Accounting for Current Liabilities

- Liabilities are probable future payments for which there are current obligations to pay due to the occurrence of past events.
- Classify liabilities as current or long-term
- Three different types of current liabilities:
    - Determinable - known and determinable in amount
    - Estimated – known and the amount can be reasonably estimated
    - Contingent - depends upon a probable future event occurring; amount may be known or reasonably estimated

Notes Payable

- Computing the interest expense, term, maturity date and maturity value of a note
- Journal entries to record issuance of a note and honoring the note at maturity date
- Accruing interest expense at the end of a period prior to maturity date.

Current Maturities of Long-Term Debt

- Portion of long-term debt, such as bonds payable, mortgages payable and installment notes payable due within one year

Accounts Payable

- Current liability account used for invoices received from vendors and suppliers

Unearned Revenue

- Results from payments received in advance of services performed or goods sold
- Creates a liability to perform the services, sell the goods or refund the payment

Payroll and Payroll Taxes Payable

- Gross wages or salaries earned does not equal net pay paid to employees
- Differences is payroll taxes withheld from employees' pay
- Withholdings are recorded as liabilities owed to government agencies levying the taxes
- Employers are also obligated for certain payroll taxes not withheld from employees' compensation

Sales Taxes payable

- Companies are required by law to collect sales tax on retail sales.
- Companies are merely a conduit for the taxes collected, recording a liability when collected and paying off the liability when the taxes are remitted to the appropriate government agency

Contingent liabilities

- Result from future events with uncertain outcomes that may result in liabilities.
- Contingent liabilities are recorded if the liability is probable and the amount can be reasonably estimated.
- Contingent liabilities are disclosed in the footnotes to the financial statements if the liability is probable and the amount cannot be reasonably estimated.
- Contingent liabilities are not recorded or disclosed when the future event is unlikely to occur.

Analysis

- Solvency Ratios
  - Times interest earned ratio measures the ability to meet interest payments as they occur.
  - Debt to assets ratio measures the proportion of assets acquired using debt
- Liquidity ratios
  - Current ratio measures the ability to use current assets to pay current liabilities in the short-term.
  - Working Capital is the excess of current assets over current liabilities
  - Neither of these measures considers the quality of the current assets or how easy it would be to actually use them to pay a liability.

Problems

Problem #1 - Classifying liabilities

A Company has the following liabilities on its trial balance:

Notes Payable due in 7 months
Wages Payable
Mortgage Payable due in 10 years
Note payable due in 15 moths payable
FICA Taxes Payable
Notes Payable due in 7 months

Required: Classify each liability as either current or long-term.

Problem #2 – Contingent Liabilities

J Company is the defendant in two lawsuits. They expect to lose the first case and estimate that the damages will be approximately $1,000,000. Although they expect to prevail in the second case, the damages will be approximately $500,00 if they lose.

Required: Identify which lawsuit(s) should be recorded as a liability and the reason for the liability.

Problem #3 – Deferred Revenue

As of October 31, P Company received $5,000,000 for advance ticket sales for a series of four concerts beginning November 5. Record the journal entries for October 31 and for the second concert on November 6.

Required: Prepare the journal entries for October 31 and for the second concert on November 6.

Problem #4 - Ratios

S Company had income before interest expense and income taxes of $12,581 million and interest expense of $1,063 million. V Company had net income of $1,613 million, income taxes of $840 million and interest expense of $1,143 million. Calculate the times interest earned for each company and comment on the results.

Required: Calculate the times interest earned for each company

Problem #5 – Payroll Liabilities

An employee earns $9,500 for the current period. FICA tax (Social security tax of 6.2% and Medicare tax of 1.45%) of 7.65% applies to all earnings. Federal income tax will be 15% of earnings and state income tax will be 3% of earnings. Federal unemployment tax rate is 0.8% and state unemployment tax rate is 3.0%.

Required: Prepare the journal entries that your company would use to record the payroll. Consider both employee and employer payroll taxes.

Multiple Choice Questions

1. Which of the following represents the correct journal entry to record a taxable cash sale of $800 if the sales tax rate is 5%?
   a) A debit to cash for $840, a debit to sales tax expense for $40, and a credit to sales revenue for $800.
   b) A debit to cash for $840, a credit to sales tax payable for $40, and a credit to sales revenue for $800.
   c) A debit to cash for $800, a credit to sales tax payable for $40, and a credit to sales revenue for $760
   d) None of the above.

2. Under what condition should a pending lawsuit be recognized as a liability on a company's balance sheet?
   a) The outcome is reasonably possible.
   b) The outcome is probable.
   c) The amount can be reasonably estimated.
   d) Both B and C.

3. M Company has been named as a plaintiff in a $5 million lawsuit filed by a customer over the addictive nature of the company's french fries. M Company's attorneys have advised them that the likelihood of a future obligation from the suit is remote. As a result of the lawsuit, M Company should:
   a) Disclose the lawsuit in the footnotes to the financial statements.
   b) Recognize a $5 million liability on its balance sheet for the contingency.
   c) Ignore the lawsuit in its financial statements.
   d) Settle with the customer immediately for $5 million to avoid harmful publicity.

4. How many of the following statements are true?
   - Solvency measures the ability to survive in the short-term
   - Liquidity measures the ability to meet all liabilities as they come due
   - A line of credit provides additional liquidity to a company
   - The times interest earned ratio measures a company's ability to pay for interest payments out of current earnings
   - The higher the debt-to-equity ratio, the less risk the company has

   a) None
   b) One
   c) Two
   d) Three

5. The monthly remittance of sales tax to the state department of revenue:
   a) Reduces stockholders' equity.
   b) Increases liabilities.
   c) Reduces liabilities.
   d) All of the above.

6. Which of the following statements regarding payroll liabilities is true?
   a) Accrued payroll includes such liabilities as retirement and health benefits not yet paid.
   b) Only employees are required to pay FICA taxes.
   c) Both employers and employees are required to pay unemployment taxes.
   d) Accrued payroll liabilities do not include any voluntary deductions by employees for charitable contributions or union dues.

7. At the beginning of the first quarter, your company borrows $20,000 for four years at 8% interest and has to repay $5,000 of principal each year. Interest is paid at the end of the second and fourth quarters, and the principal is due at the end of the year. How would this information be reported on the balance sheet at the end of the **first** quarter?
   a) $400 as interest expense and $20,000 under long-term debt.
   b) $400 as interest payable, $5,000 as current portion of long-term debt under current liabilities, and $15,000 under long-term debt.
   c) $1,600 of interest under current liabilities, $5,000 as current portion of long-term debt under current liabilities and $15,000 under long-term debt.
   d) $400 as interest payable under current liabilities and $20,000 under long-term debt.

8. Which of the following is NOT true regarding the current ratio?
   a) If a company has more current assets than liquid assets, the current ratio will be greater than 1.0.
   b) A high quick ratio suggests a high ability to pay current liabilities.
   c) Current assets include cash and cash equivalents, short-term investments, and net accounts receivable.
   d) A current ratio greater than 1 implies a company could not pay all of its current liabilities.

9. During one pay period, Y Company distributes $130,500 to employees as net pay. The income tax withholdings were $19,000 and the FICA withholdings were $5,000. The total compensation expense to the company for this pay period, excluding any unemployment taxes, was:
   a) $149,500
   b) $130,500
   c) $154,500
   d) $159,500

10. Accounts payable are:
   a) Long-term liabilities.
   b) Not usually due on specific dates.
   c) Amounts owed to suppliers for products and/or services purchased on credit.
   d) Always payable within 30 days.

11. Which of the following do not apply to unearned revenues?
   a) Amounts to be received in the future from customers for delivery of products or services in the current period.
   b) Also called collections in advance.
   c) Also called deferred revenues.
   d) Amounts received in advance from customers for future delivery of products or services.

12. Contingent liabilities must be recorded if:
   a) The future event is remote.
   b) The future event is probable and the amount owed can be reasonably estimated.
   c) The future event is reasonably possible but not estimable.
   d) The future event is probable but not estimable.

13. Times interest earned is calculated by:
   a) Dividing interest expense by income before interest expense.
   b) Dividing income before interest expense and income taxes by interest expense.
   c) Multiplying interest expense by income before interest expense.
   d) Dividing income before interest expense by interest expense and income taxes.

14. The entry to accrue payroll expenses and liabilities for *employees* will not include:
    a) Liabilities to federal and state governments.
    b) Expenses for gross wages and salaries.
    c) Expenses for state unemployment.
    d) Expenses for the employee portion of any medical insurance.

15. Employer payroll taxes:
    a) Are added expenses beyond that for the wages and salaries earned by employees.
    b) Represent the federal taxes withheld from employees.
    c) Represent the social security taxes withheld from employees.
    d) Are paid by the employee.

Solutions to Problems

Problem #1 - Classifying liabilities

Current	Notes Payable due in 7 months Wages Payable FICA Taxes Payable First year of Mortgage Payable due in 10 years First 12 months of Note payable due in 15 months payable monthly
Long-term	Final 9 years of Mortgage Payable due in 10 years Final 3 months of Note payable due in 15 months payable monthly

Problem #2– Contingent Liabilities

Although the amount of damages can be estimated for both lawsuits, only the first case should be recorded as a liability since there is a high probability of loss. The second case should be disclosed in the footnotes to the financial statements.

Problem #3 – Deferred Revenue

Oct. 31	Cash	5,000,000	
	Unearned Ticket Revenue		5,000,000
Nov. 6	Unearned Ticket Revenue	1,250,000	
	Earned Ticket Revenue		1,250,000

Problem #4 - Ratios

S Company $\frac{\$12,581}{1,063} = 11.8$

V Company $\frac{\$3,596}{1,143} = 3.1$

Problem #5 – Payroll Liabilities

Wages and salaries payable	9,500.00	
Federal income taxes payable		1,425.00
State income taxes payable		285.00
FICA taxes payable		726.75
Cash		7,063.25
Payroll tax expense	1,087.75	
FICA taxes payable		726.75
Federal unemployment tax payable		76.00
State unemployment tax payable		285.00

Solutions to Multiple Choice Questions

1.	B
2.	D
3.	C
4.	C
5.	C
6.	A
7.	B
8.	D
9.	D
10.	C
11.	A
12.	B
13.	B
14.	C
15.	A