

# **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**

#### **Notes payable**

## Key Topics to Know

### Elements of Liabilities

- A liability is a debt owed to a third party; a company cannot have a liability to itself.
- 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
  - a **PRESENT** obligation to pay a third party which will result in
  - a payment at some **FUTURE** date.
- A liability may be satisfied by the exchange of cash or other assets or by providing services.
- 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 of Liabilities

- Just as for assets, liabilities are classified as current or long-term, depending on the due date.
- Current liabilities are due to be paid within the next twelve months.
- Long-term liabilities are due to be paid after the next twelve months have passed.
- 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.

### Uncertain Liabilities

- Uncertainty arises because a liability may be incurred before all the facts are known.
- Liabilities may be uncertain as to:

- **Amount to pay**
- **When to pay**
- **Whom to Pay**
- 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.
- Known liabilities include short-term notes payable.
- In previous chapters, many of the most common known liabilities have been discussed:
  - Accounts Payable
  - Sales Taxes Payable
  - Unearned Revenues

## 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.

- Notes payable replaces notes receivable
- Interest expense replaces interest revenue
- Cash is paid rather than received
- Notes payable is a liability whereas notes receivable is an asset

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. Journalize the entries to record issuing the note and payment on the due date.

**Solution #1:**

a.	Accounts payable	12,000	
	Notes payable		12,000
b.	Notes payable	12,000	
	Interest expense	300	
	Cash		12,300
	<i>Interest: 12,000 * .10 * 90/360 = 300</i>		

**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 #2:**

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

**Solution #2:**

Interest expense	100	
Interest payable		100

*Interest expense = principal x rate x time*  
*100 = 15,000 x .08 x 30 days/360 days*

**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 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.
- Dec. 31 Accrued interest on the outstanding Notes Payable. There are currently four outstanding notes payable to Midland Bank.

**Practice Problem #2:**

On November 1, 2012, Dual Systems borrows \$200,000 to expand operations. Dual Systems signs a six-month, 9% promissory note. Interest is payable at maturity. Dual System's year-end is December 31.

Required:

- a) Record the issuance of the note by Dual Systems.
- b) Record the appropriate adjusting entry for the note by Dual Systems on December 31, 2012
- c) Record the payment of the note by Dual Systems at maturity on April 30, 2013.

**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 debited and the appropriate balance sheet account is credited. Note that an expense is not recorded when the warranty goods/services are provided.

**Practice Problem #3**

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.  |

**Practice Problem #4:**

Rotary Tools sells power tools and backs each product it sells with a one-year warranty against defects. Based on previous experience, the company expects warranty costs to be approximately 5% of sales. By the end of the first year, sales and actual warranty expenditures are \$800,000 and \$13,000, respectively.

Required:

- Does this situation represent a contingent liability? Why or why not?
- Record warranty expense and warranty liability for the year based on 5% of sales.
- Record the reduction in warranty liability and the reduction in cash of \$13,000 incurred during the year.
- What is the balance in the Warranty Liability account after the entries in parts b) and c)?

## Contingent Liabilities

Both a contingent liability and a known liability require the same three 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.

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.

The more certainty that is involved, the more information that is recorded or disclosed:

- Contingent liabilities are recorded when the future event is probable and the amount is known or can be reasonably estimated.
- 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.
- Contingent liabilities are not recorded or disclosed when the future event is unlikely to occur.

### **Practice Problem #5:**

Match (by number) the correct reporting method for each of the items listed below.

- C Current liability
- L Long-term liability
- D Disclosure in footnotes only
- N Not reported

- \_\_\_\_\_ a) Notes payable due in 2 years
- \_\_\_\_\_ b) Customer advances
- \_\_\_\_\_ c) Commercial paper
- \_\_\_\_\_ d) Unused line of credit
- \_\_\_\_\_ e) A contingent liability that is probable to occur within the next year but cannot be estimated

## Sample True / False Questions

1. In a classified balance sheet, we categorize all liabilities as current.  
True False
2. Commonly, current liabilities are payable within one year, and long-term liabilities are payable more than one year from now.  
True False
3. Interest is stated in terms of an annual percentage rate to be applied to the face value of the loan.  
True False
4. Interest expense is recorded in the period in which it is paid, rather than in the period incurred.  
True False
5. Accounts payable are amounts the company owes to suppliers of merchandise or services that it has bought on credit.  
True False
6. When a company receives cash in advance, it debits Cash and credits a revenue account called Unearned Revenue.  
True False
7. Airlines do not record revenue when a ticket is sold, but wait to record revenue until the actual flight occurs.  
True False
8. Sales taxes collected from customers by the seller are not an expense, instead they represent current liabilities payable to the government.  
True False
9. Long-term obligations such as notes, mortgages, and bonds are reported as long-term liabilities when they become payable within the upcoming year.  
True False
10. A contingent liability is an existing, uncertain situation that might

result in a loss.

True False

11. We record a contingent liability when the likelihood of the loss occurring is reasonably possible and the amount can be reasonably estimated.  
True False
12. The journal entry to record a contingent liability requires a debit to a loss (or expense) account and a credit to a liability.  
True False
13. If the likelihood of a loss is reasonably possible rather than probable, we record no entry, but make full disclosure in a footnote to the financial statements to describe the contingency.  
True False
14. If the likelihood of loss is remote, disclosure usually is not required.  
True False
15. The balance in the Warranty Liability account is always equal to Warranty Expense.  
True False

## Sample Multiple Choice Questions

1. On June 5, Apex issued a \$30,000, 8% 120-day note payable to Jones Co. Assume the fiscal of Apex ends June 30. What is the interest expense recognized by Apex in the current fiscal year?
  - a) \$166.67
  - b) \$800.00
  - c) \$373.33
  - d) \$633.34
  
2. On June 5, Apex issued a \$30,000, 8% 120-day note payable to Jones. Assume the fiscal year of Jones ends June 30. What is the interest revenue recognized by Jones in the following fiscal year?
  - a) \$633.33
  - b) \$400.00
  - c) \$373.33
  - d) \$166.67
  
3. 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
  
4. The liability for a product warranty should be recorded 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. Which of the following is not a typical current liability?
  - a) Sales Taxes Payable
  - b) Mortgage Payable
  - c) Unearned Revenue
  - d) Interest Payable

6. 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 |
7. On March 5, Eaton Corporation issued a 90-day, 6% note for \$5,000 to Roan, Inc. for merchandise purchased. The entry to record the issuance of the note would be:
- |                          |       |       |
|--------------------------|-------|-------|
| a) Merchandise Inventory | 5,000 |       |
| Notes Payable            |       | 5,000 |
| b) Merchandise Inventory | 5,300 |       |
| Notes Payable            |       | 5,300 |
| c) Merchandise Inventory | 4,925 |       |
| Interest Expense         | 75    |       |
| Notes Payable            |       | 5,000 |
| d) Merchandise Inventory | 4,925 |       |
| Notes Payable            |       | 4,925 |
8. 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

Use the following information to answer questions 11 and 12:

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 also concerned about rumors that other lawsuits may be filed in the future.

9. Land should record expense in the amount of:
  - a. \$500,000
  - b. \$1,000,000
  - c. \$1,500,000
  - d. Some other amount
  
10. 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
  
11. On November 1, 2012, The Bagel Factory signed a \$100,000, 6%, six-month note payable with the amount borrowed plus accrued interest due on April 30, 2013. The Bagel Factory should report interest payable at December 31, 2012, in the amount of:
  - a) \$0
  - b) \$1,000
  - c) \$2,000
  - d) \$3,000
  
12. On November 1, 2012, The Bagel Factory signed a \$100,000, 6%, six-month note payable with the amount borrowed plus accrued interest due on April 30, 2013. The Bagel Factory records the appropriate adjusting entry for the note on December 31, 2012. In recording the payment of the note plus accrued interest at maturity on April 30, 2013, The Bagel Factory would
  - a) Debit Interest Expense, \$2,000.
  - b) Debit Interest Expense, \$1,000.
  - c) Debit Interest Payable, \$2,000.
  - d) Debit Interest Expense, \$3,000.
  
13. On December 1, 2012, Old World Deli signed a \$300,000, 5%, six-month note payable with the amount borrowed plus accrued interest due on May 31, 2013. Old World Deli records the appropriate adjusting entry for the note on December 31, 2012. What amount of cash will be needed to pay back the note payable plus any accrued interest on May 31, 2013?
  - a) \$300,000
  - b) \$301,250
  - c) \$306,250
  - d) \$307,500
  
14. Sales taxes collected by a company on behalf of the state and local

government are recorded by:

- a) A debit to an expense account.
  - b) A credit to a revenue account.
  - c) A debit to a revenue account.
  - d) A credit to a liability account.
15. The current portion of long-term debt should be
- a) Reported as a current liability on the balance sheet.
  - b) Reported as a long-term liability on the balance sheet.
  - c) Combined with the rest of the long-term debt on the balance sheet.
  - d) Paid immediately.
16. If management can estimate the amount of loss that will occur due to litigation against the company, and the likelihood of the loss is *probable*, a contingent liability should be
- a) Disclosed, but not reported as a liability.
  - b) Disclosed and reported as a liability.
  - c) Neither disclosed nor reported as a liability.
  - d) Reported as a liability, but not disclosed.
17. Reeves Co. filed suit against Higgins, Inc., seeking damages for copyright violations. Higgins believes it is probable that Higgins will settle the lawsuit for an estimated amount of \$100,000. How should Higgins report this litigation?
- a) Disclosed, but not reported as a liability.
  - b) Disclosed and reported as a liability.
  - c) Neither disclosed nor reported as a liability.
  - d) Reported as a liability, but not disclosed.
18. Strikers, Inc. sells soccer goals to customers over the Internet. History has shown that 2% of Strikers' goals are faulty and will need repair under the warranty program. For the year, Strikers has sold 4,000 goals and 45 have been repaired. If the estimated cost to repair a goal is \$200, what would be the Warranty Liability at the end of the year?
- a) \$0.
  - b) \$16,000.
  - c) \$7,000.
  - d) \$6,750.

19. Bears Inc. sells football helmets with a one year warranty. Based upon previous years, Bears Inc. estimates that 3% of products sold each year will need repairs or be replaced within the following year. What effect would this warranty have on assets, liabilities, and stockholders' equity in 2012?
  - a) A decrease in assets and decrease in stockholders' equity.
  - b) No journal entry is necessary until products under warranty are returned.
  - c) An increase in stockholders' equity and a decrease in liabilities.
  - d) A decrease in stockholders' equity and an increase in liabilities.
  
20. Talks-A-Lot, Inc. sells cell phones to customers and expects that 10% of phones sold will be returned for repair under its warranty program. The average repair cost is \$75 per phone. For 2012, Talks-A-Lot has sold 750 cell phones and has repaired 30 of them as of December 31, 2012. What amount of warranty expense should be reported at December 31, 2012?
  - a) A. \$2,250.
  - b) B. \$3,375.
  - c) C. \$5,625.
  - d) D. None, all expected returns from warranties have been received.
  
21. A contingent liability should be disclosed in a note to the financial statements rather than being recorded if:
  - a) The likelihood of a loss is remote.
  - b) The incurrence of a loss is reasonably possible.
  - c) The incurrence of a loss is probable.
  - d) The likelihood of a loss is eighty percent.
  
22. Which of the following is a contingency that should be recorded?
  - a) The company is being sued and a loss is reasonably possible and reasonably estimable.
  - b) The company deducts life insurance premiums from employees' paychecks.
  - c) The company offers a two-year warranty and the expenses can be reasonably estimated.
  - d) It is probable that the company will receive \$100,000 in settlement of a lawsuit.

# Solutions to Practice Problems

## Practice Problem #1

3/15	Merchandise Inventory	33,000	
	Accounts payable		33,000
4/14	Accounts payable	33,000	
	Notes Payable		33,000
5/14	Notes Payable	33,000	
	Interest expense	220	
	Cash		33,220
	<i>Interest: 33,000 * .08 * 30/360 = 220</i>		
6/15	Cash	90,000	
	Notes Payable		90,000
7/16	Notes Payable	9,000	
	Interest Expense		90
	Cash		9,090
	<i>Interest Due: 9,000 * .12 * 30/360 = 90</i>		
8/15	Notes Payable	9,000	
	Interest Expense		180
	Cash		9,180
	<i>Interest Due: 9,000 * .12 * 60/360 = 180</i>		
9/5	Notes Payable	72,000	
	Cash		72,000
12/31	Interest expense	2,388	
	Interest payable		2,388
	<i>Interest: 36,000 * .12 * 199/360 = 2,388</i>		

**Practice Problem #2**

11/1	Cash	200,000	
	Notes Payable		200,000
12/31	Interest expense	3,000	
	Interest payable		3,000
	<i>Interest: 200,000 * .09 * 60/360 = 3,000</i>		
4/30	Notes Payable	200,000	
	Interest Expense	6,000	
	Interest payable	3,000	
	Cash		209,000
	<i>Interest Due: 200,000 * .09 * 120/360 = 6,000</i>		

**Practice Problem #3**

12/31	Cash	1,000,000	
	Sales		1,000,000
	Cost of Goods Sold	600,000	
	Merchandise inventory		600,000
	Warranty expense	20,000	
	Estimated warranty liability		20,000
3/31	Estimated warranty liability	12,500	
	Repair parts inventory		12,500
5/15	Cash	200,000	
	Sales		200,000
	Cost of Goods Sold	120,000	
	Merchandise inventory		120,000
	Warranty expense	4,000	
	Estimated warranty liability		4,000
6/30	Estimated warranty liability	18,000	
	Merchandise inventory		18,000
6/30	Cash	300,000	
	Sales		300,000

Cost of Goods Sold	180,000	
Merchandise inventory		180,000
Warranty expense	6,000	
Estimated warranty liability		6,000

**Practice Problem #4:**

a) Yes, it's probable that costs for warranties will be incurred and based on previous experience the company can reasonably estimate the amount.

b) Warranty expense	40,000	
Estimated warranty liability		40,000
c) Estimated warranty liability	13,000	
Cash		13,000

Estimated Warranty Liability	
	\$40,000 expense
Payment \$13,000	
	\$27,000 balance

**Practice Problem #5:**

1. L
2. C
3. C
4. D
5. D

## Solutions to True / False Questions

1. False - Liabilities may be classified as either current or long-term.
2. True
3. True
4. False - Interest expense is recorded in the period incurred, not in the period in which we pay it.
5. True
6. False - When a company receives cash in advance, it debits Cash and credits a liability account called Unearned Revenue.
7. True
8. True
9. False - These liabilities usually are reclassified and reported as current liabilities when they become payable within the upcoming year.
10. True
11. False - We record a contingent liability when the likelihood of the loss occurring is **probable** and the amount can be reasonably estimated.
12. True
13. True
14. True
15. False - The Warranty Liability account is increased by warranty expense, but it is also reduced over time by actual warranty expenditures.

# Solutions to Multiple Choice Questions

1. A
2. A
3. D
4. D
5. B
6. D
7. A
8. D
9. A
10. B
11. B
12. A
13. D
14. D
15. A
16. B
17. B
18. C
19. D
20. C
21. B
22. D