LEARNING OBJECTIVES

After studying this chapter, you should be able to:

1. Describe the nature, type, and valuation of current liabilities.
2. Explain the classification issues of short-term debt expected to be refinanced.
3. Identify types of employee-related liabilities.
4. Identify the criteria used to account for and disclose gain and loss contingencies.
5. Explain the accounting for different types of loss contingencies.
6. Indicate how to present and analyze liabilities and contingencies.
Current Liabilities

“What is a Liability?”

The FASB, defined liabilities as:

“Probable Future Sacrifices of Economic Benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.”

Recall: Current assets are cash or other assets that companies reasonably expect to convert into cash, sell, or consume in operations within a single operating cycle or within a year.

Current liabilities are “obligations whose liquidation is reasonably expected to require use of existing resources properly classified as current assets, or the creation of other current liabilities.”

Operating cycle: period of time elapsing between the acquisition of goods and services and the final cash realization resulting from sales and subsequent collections.
Current Liabilities

Typical Current Liabilities:

- Accounts payable.
- Notes payable.
- Current maturities of long-term debt.
- Short-term obligations expected to be refinanced.
- Dividends payable.
- Customer advances and deposits.
- Unearned revenues.
- Sales taxes payable.
- Income taxes payable.
- Employee-related liabilities.

Current Liabilities

Accounts Payable (trade accounts payable)

Balances owed to others for goods, supplies, or services purchased on open account.

- Time lag between the receipt of services or acquisition of title to assets and the payment for them.
- Terms of the sale (e.g., 2/10, n/30 or 1/10, E.O.M.) usually state period of extended credit, commonly 30 to 60 days.
Current Liabilities

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

- Arise from purchases, financing, or other transactions.
- Classified as short-term or long-term.
- May be interest-bearing or zero-interest-bearing.

Illustration:
Castle National Bank agrees to lend $100,000 on March 1, 2014, to Landscape Co. if Landscape signs a $100,000, 6 percent, four-month note. Landscape records the cash received on March 1 as follows:

<table>
<thead>
<tr>
<th>Cash</th>
<th>100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Notes Payable</td>
<td>100,000</td>
</tr>
</tbody>
</table>

Current Liabilities

Interest-Bearing Note Issued

Illustration: Castle National Bank agrees to lend $100,000 on March 1, 2014, to Landscape Co. if Landscape signs a $100,000, 6 percent, four-month note. Landscape records the cash received on March 1 as follows:

<table>
<thead>
<tr>
<th>Cash</th>
<th>100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Notes Payable</td>
<td>100,000</td>
</tr>
</tbody>
</table>
Current Liabilities

If Landscape prepares financial statements semiannually, it makes the following adjusting entry to recognize interest expense and interest payable at June 30:

Interest calculation = ($100,000 x 6% x 4/12) = $2,000

<table>
<thead>
<tr>
<th>Account Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest Expense</td>
<td>2,000</td>
</tr>
<tr>
<td>Interest Payable</td>
<td>2,000</td>
</tr>
</tbody>
</table>

Current Liabilities

At maturity (July 1), Landscape records payment of the note and accrued interest as follows.

<table>
<thead>
<tr>
<th>Account Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Notes payable</td>
<td>100,000</td>
</tr>
<tr>
<td>Interest Payable</td>
<td>2,000</td>
</tr>
<tr>
<td>Cash</td>
<td>102,000</td>
</tr>
</tbody>
</table>
**Current Liabilities**

**Zero-Interest-Bearing Note Issued**

**Illustration:** On March 1, Landscape issues a $102,000, four-month, zero-interest-bearing note to Castle National Bank. The present value of the note is $100,000. Landscape records this transaction as follows.

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>100,000</td>
</tr>
<tr>
<td>Discount on Notes Payable</td>
<td>2,000</td>
</tr>
<tr>
<td>Notes Payable</td>
<td>102,000</td>
</tr>
</tbody>
</table>

**Discount on Notes Payable** is a contra account to Notes Payable, and therefore is subtracted from Notes Payable on the balance sheet.

<table>
<thead>
<tr>
<th>Current liabilities</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Notes payable</td>
<td>$102,000</td>
</tr>
<tr>
<td>Less: Discount on notes payable</td>
<td>2,000</td>
</tr>
<tr>
<td></td>
<td>$100,000</td>
</tr>
</tbody>
</table>

Discount on notes payable:
- Represents the cost of borrowing.
- Debited to interest expense over the life of the note.
- Represents interest expense chargeable to future periods.
Illustration: (Accounts and Notes Payable) The following are selected 2014 transactions of Darby Corporation.

**Sept. 1** - Purchased inventory from Orion Company on account for $50,000. Darby records purchases gross and uses a periodic inventory system.

**Oct. 1** - Issued a $50,000, 12-month, 8% note to Orion in payment of account.

**Oct. 1** - Borrowed $75,000 from the Shore Bank by signing a 12-month, zero-interest-bearing $81,000 note.

Prepare journal entries for the selected transactions.

---

**Current Liabilities**

**Sept. 1** - Purchased inventory from Orion Company on account for $50,000. Darby records purchases gross and uses a periodic inventory system.

<table>
<thead>
<tr>
<th>Date</th>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sept. 1</td>
<td>Purchases</td>
<td>50,000</td>
</tr>
<tr>
<td></td>
<td>Accounts Payable</td>
<td>50,000</td>
</tr>
</tbody>
</table>
## Current Liabilities

**Oct. 1 - Issued a $50,000, 12-month, 8% note to Orion in payment of account.**

<table>
<thead>
<tr>
<th>Date</th>
<th>Account Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Oct. 1</td>
<td>Accounts Payable</td>
<td>50,000</td>
</tr>
<tr>
<td></td>
<td>Notes Payable</td>
<td>50,000</td>
</tr>
</tbody>
</table>

**Interest calculation** = ($50,000 x 8% x 3/12) = $1,000

<table>
<thead>
<tr>
<th>Date</th>
<th>Account Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dec. 31</td>
<td>Interest Expense</td>
<td>1,000</td>
</tr>
<tr>
<td></td>
<td>Interest Payable</td>
<td>1,000</td>
</tr>
</tbody>
</table>

**LO 1 Describe the nature, type, and valuation of current liabilities.**

---

## Current Liabilities

**Oct. 1 - Borrowed $75,000 from the Shore Bank by signing a 12-month, zero-interest-bearing $81,000 note.**

<table>
<thead>
<tr>
<th>Date</th>
<th>Account Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Oct. 1</td>
<td>Cash</td>
<td>75,000</td>
</tr>
<tr>
<td></td>
<td>Discount on Notes Payable</td>
<td>6,000</td>
</tr>
<tr>
<td></td>
<td>Notes Payable</td>
<td>81,000</td>
</tr>
</tbody>
</table>

**Interest calculation** = ($6,000 x 3/12) = $1,500

<table>
<thead>
<tr>
<th>Date</th>
<th>Account Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dec. 31</td>
<td>Interest Expense</td>
<td>1,500</td>
</tr>
<tr>
<td></td>
<td>Discount on Notes Payable</td>
<td>1,500</td>
</tr>
</tbody>
</table>

**LO 1 Describe the nature, type, and valuation of current liabilities.**
Current Liabilities

Current Maturities of Long-Term Debt

Portion of bonds, mortgage notes, and other long-term indebtedness that matures within the next fiscal year.

Exclude long-term debts maturing currently if they are to be:

1. Retired by assets accumulated that have not been shown as current assets,
2. Refinanced, or retired from the proceeds of a new debt issue, or
3. Converted into capital stock.

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

1. Describe the nature, type, and valuation of current liabilities.
2. Explain the classification issues of short-term debt expected to be refinanced.
3. Identify types of employee-related liabilities.
4. Identify the criteria used to account for and disclose gain and loss contingencies.
5. Explain the accounting for different types of loss contingencies.
6. Indicate how to present and analyze liabilities and contingencies.
Current Liabilities

Short-Term Obligations Expected to Be Refinanced

Exclude from current liabilities if both of the following conditions are met:

1. Must intend to refinance the obligation on a long-term basis.
2. Must demonstrate an ability to refinance:
   - Actual refinancing.
   - Enter into a financing agreement.

International Perspective

IFRS requires that the current portion of long-term debt be classified as current unless an agreement to refinance on a long-term basis is completed before the date of the financial statements.
Illustration: On December 31, 2014, Alexander Company had $1,200,000 of short-term debt in the form of notes payable due February 2, 2015. On January 21, 2015, the company issued 25,000 shares of its common stock for $36 per share, receiving $900,000 proceeds after brokerage fees and other costs of issuance. On February 2, 2015, the proceeds from the stock sale, supplemented by an additional $300,000 cash, are used to liquidate the $1,200,000 debt. The December 31, 2014, balance sheet is issued on February 23, 2015.

Instructions:
Show how the $1,200,000 of short-term debt should be presented on the December 31, 2014, balance sheet, including note disclosure.
The evaluation of credit quality involves more than simply assessing a company's ability to repay loans. Credit analysts also evaluate debt management strategies. Analysts and investors will reward what they view as prudent management decisions with lower debt service costs and a higher stock price. The wrong decisions can bring higher debt costs and lower stock prices.

General Electric Capital Corp., a subsidiary of General Electric, experienced the negative effects of market scrutiny of its debt management policies. Analysts complained that GE had been slow to refinance its mountains of short-term debt. GE had issued these current obligations, with maturities of 270 days or less, when interest rates were low. However, in light of expectations that the Fed would raise interest rates, analysts began to worry about the higher interest costs GE would pay when it refinanced these loans. Some analysts recommended that it was time to reduce dependence on short-term credit. The reasoning goes that a shift to more dependable long-term debt, thereby locking in slightly higher rates for the long-term, is the better way to go.

Thus, scrutiny of GE debt strategies led to analysts' concerns about GE's earnings prospects. Investors took the analysis to heart, and GE experienced a two-day 6 percent drop in its stock price.


### Current Liabilities

#### Dividends Payable

Amount owed by a corporation to its stockholders as a result of board of directors' authorization.

- Generally paid within three months.
- Undeclared dividends on cumulative preferred stock not recognized as a liability.
- Dividends payable in the form of additional shares of stock are reported in stockholders' equity.
Current Liabilities

Customer Advances and Deposits

Returnable cash deposits received from customers and employees.

- To guarantee performance of a contract or service or
- As guarantees to cover payment of expected future obligations.
- May be classified as current or long-term liabilities.

Unearned Revenues

Payment received before delivering goods or rendering services?

<table>
<thead>
<tr>
<th>Type of Business</th>
<th>Account Title</th>
</tr>
</thead>
<tbody>
<tr>
<td>Airline</td>
<td>Unearned Revenue</td>
</tr>
<tr>
<td>Magazine publisher</td>
<td>Unearned Ticket Revenue</td>
</tr>
<tr>
<td>Hotel</td>
<td>Unearned Subscription Revenue</td>
</tr>
<tr>
<td>Auto dealer</td>
<td>Unearned Rent Revenue</td>
</tr>
<tr>
<td>Retailers</td>
<td>Unearned Warranty Revenue</td>
</tr>
<tr>
<td></td>
<td>Unearned Gift Card Revenue</td>
</tr>
</tbody>
</table>

|                  | Earned Revenue                |
|                  | Passenger Revenue             |
|                  | Subscription Revenue          |
|                  | Rent Revenue                  |
|                  | Warranty Revenue              |
|                  | Sales Revenue                 |

LO 2: Explain the classification issues of short-term debt expected to be refinanced.
Current Liabilities

Illustration: Allstate University sells 10,000 season football tickets at $50 each for its five-game home schedule. Allstate University records the sales of season tickets as follows.

Aug. 6  Cash  500,000
        Unearned Sales Revenue  500,000
(10,000 x $50 = $500,000)

As each game is completed, Allstate makes the following entry.

Dec. 31  Unearned Sales Revenue  100,000
        Sales Revenue  100,000
(500,000 ÷ 5 games = $100,000 per game)

What do the numbers mean? MICROSOFT'S LIABILITIES-GOOD OR BAD?

Users of financial statements generally examine current liabilities to assess a company's liquidity and overall financial flexibility. Companies must pay many current liabilities, such as accounts payable, wages payable, and taxes payable, sooner rather than later. A substantial increase in these liabilities should raise a red flag about a company's financial position.

This is not the case for all current liabilities. For example, Microsoft has a current liability entitled "Unearned revenue" of $14,830 million in 2010 that has increased year after year. Unearned revenue is a liability that arises from sales of Microsoft products such as Internet Explorer and Windows XP. Microsoft also has provided coupons for upgrades to its programs to bolster sales of its Xbox consoles. At the time of a sale, customers pay not only for the current version of the software but also for future upgrades. Microsoft recognizes sales revenue from the current version of the software and records as a liability (unearned revenue) the value of future upgrades to the software that it "owes" to customers.

Market analysts read such an increase in unearned revenue as a positive signal about Microsoft's sales and profitability. When Microsoft's sales are growing, its unearned revenue account increases. Thus, an increase in a liability is good news about Microsoft sales. At the same time, a decline in unearned revenue is bad news. As one analyst noted, a slowdown or reversal of the growth in Microsoft's unearned revenues indicates slowing sales, which is bad news for investors. Thus, increases in current liabilities can sometimes be viewed as good signs instead of bad.

Retailers must collect sales taxes from customers on transfers of tangible personal property and on certain services and then remit to the proper governmental authority.

Illustration: Prepare the entry to record sales taxes assuming there was a sale of $3,000 when a 4 percent sales tax is in effect.

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>3,120</td>
</tr>
<tr>
<td>Sales Revenue</td>
<td>3,000</td>
</tr>
<tr>
<td>Sales Taxes Payable ($3,000 x 4% = $120)</td>
<td>1,800</td>
</tr>
</tbody>
</table>
Many companies do not segregate the sales tax and the amount of the sale at the time of sale. Instead, the company credits both amounts in total in the Sales Revenue account.

**Illustration:** Assume the Sales Revenue account balance of $150,000 includes sales taxes of 4 percent. Prepare the entry to record the amount due the taxing unit.

**Tax calculation** = ($150,000 ÷ 1.04 = $144,230.77 - $150,000 = $5,769.23)

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales Revenue</td>
<td>5,769.23</td>
</tr>
<tr>
<td>Sales Taxes Payable</td>
<td>5,769.23</td>
</tr>
</tbody>
</table>

**Current Liabilities**

Businesses must prepare an income tax return and compute the income tax payable.

- Taxes payable are a current liability.
- Corporations must make periodic tax payments.
- Differences between taxable income (tax law) and accounting income (GAAP) sometimes occur (Chapter 19).
LEARNING OBJECTIVES

After studying this chapter, you should be able to:

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Current Liabilities

Employee-Related Liabilities

Amounts owed to employees for salaries or wages are reported as a current liability.

Current liabilities related to employee compensation may include:

- Payroll deductions.
- Compensated absences.
- Bonuses.
Current Liabilities

Payroll Deductions

Most common types of payroll deductions are taxes, insurance premiums, employee savings, and union dues.

Social Security Taxes (since January 1, 1937).

► Federal Old Age, Survivor, and Disability Insurance (OASDI) benefits for certain individuals and their families.
► Funds from taxes levied on both employer and employee.
► Current rate 6.2 percent based on the employee’s gross pay up to a $110,100 annual limit.
► OASDI tax is usually referred to as FICA.

Social Security Taxes

In 1965, Congress passed the first federal health insurance program for the aged—popularly known as Medicare.

► Alleviates the high cost of medical care for those over age 65.
► Hospital Insurance tax, paid by both employee and employer at the rate of 1.45 percent on the employee’s total compensation.
► OASDI tax (FICA) and the federal Hospital Insurance Tax is referred to as the Social Security tax.
Payroll Deductions

Unemployment Taxes.

Provides a system of unemployment insurance.

- Federal Unemployment Tax Act (FUTA):
  - Only employers pay the unemployment tax.
  - Rate is 6.2 percent on the first $7,000 of compensation paid to each employee during the calendar year.
  - If employer is subject to a state unemployment tax of 5.4 percent or more it receives a tax credit (not to exceed 5.4 percent) and pays only 0.8 percent tax to the federal government.

State unemployment compensation laws differ both from the federal law and among various states.

Employers must refer to the unemployment tax laws in each state in which they pay wages and salaries.
Payroll Deductions

*Income Tax Withholding.*

- Federal and some state income tax laws require employers to withhold from each employee’s pay the applicable income tax due on those wages.

<table>
<thead>
<tr>
<th>Item</th>
<th>Who Pays</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income tax withholding</td>
<td>Employee</td>
</tr>
<tr>
<td>FICA taxes—employee share</td>
<td>Employee</td>
</tr>
<tr>
<td>Union dues</td>
<td>Employer</td>
</tr>
<tr>
<td>FICA taxes—employer share</td>
<td>Employer</td>
</tr>
<tr>
<td>Federal unemployment</td>
<td>Employer</td>
</tr>
<tr>
<td>State unemployment</td>
<td>Employer</td>
</tr>
</tbody>
</table>

**Illustration 13-5**

Summary of Payroll Liabilities

Illustration: Assume a weekly payroll of $10,000 entirely subject to F.I.C.A. and Medicare (7.65%), federal (0.8%) and state (4%) unemployment taxes, with income tax withholding of $1,320 and union dues of $88 deducted. The company records the salaries and wages paid and the **employee payroll deductions** as follows:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salaries and Wages Expense</td>
<td>10,000</td>
</tr>
<tr>
<td>Withholding Taxes Payable</td>
<td>1,320</td>
</tr>
<tr>
<td>FICA Taxes Payable</td>
<td>765</td>
</tr>
<tr>
<td>Union Dues Payable</td>
<td>88</td>
</tr>
<tr>
<td>Cash</td>
<td>7,827</td>
</tr>
</tbody>
</table>

**LO 3 Identify types of employee-related liabilities.**
Illustration: Assume a weekly payroll of $10,000 entirely subject to F.I.C.A. and Medicare (7.65%), federal (0.8%) and state (4%) unemployment taxes, with income tax withholding of $1,320 and union dues of $88 deducted. The company records the employers payroll taxes as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Payroll Tax Expense</td>
<td>1,245</td>
</tr>
<tr>
<td>FICA Taxes Payable</td>
<td>765</td>
</tr>
<tr>
<td>FUTA Taxes Payable</td>
<td>80</td>
</tr>
<tr>
<td>SUTA Taxes Payable</td>
<td>400</td>
</tr>
</tbody>
</table>

Compensated Absences

Paid absences for vacation, illness, and holidays.

Accrue a liability if all the following conditions exist.

- The employer’s obligation is attributable to employees’ services **already rendered**.
- The obligation relates to rights that **vest or accumulate**.
- Payment of the compensation is **probable**.
- The amount can be **reasonably estimated**.
Compensated Absences

**Illustration 13-6**
Balance Sheet Presentation of Accrual for Compensated Absences

### Clarcor Inc.

<table>
<thead>
<tr>
<th>Current liabilities</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable</td>
<td>$  6,308</td>
</tr>
<tr>
<td>Accrued salaries, wages and commissions</td>
<td>2,278</td>
</tr>
<tr>
<td>Compensated absences</td>
<td>2,271</td>
</tr>
<tr>
<td>Accrued pension liabilities</td>
<td>1,023</td>
</tr>
<tr>
<td>Other accrued liabilities</td>
<td>4,572</td>
</tr>
<tr>
<td><strong>Total Current Liabilities</strong></td>
<td><strong>$16,552</strong></td>
</tr>
</tbody>
</table>

**LO 3** Identify types of employee-related liabilities.

---

### Current Liabilities

**Illustration:** Amutron Inc. employs 10 individuals and pays each $480 per week. Employees earned 20 unused vacation weeks in 2014. In 2015, the employees used the vacation weeks, but now they each earn $540 per week. Amutron accrues the accumulated vacation pay on December 31, 2014, as follows.

\[
\begin{align*}
\text{Salaries and Wages Expense} & \quad 9,600 \\
\text{Salaries and Wages Payable (} & \times 20) \quad 9,600
\end{align*}
\]

In 2015, it records the payment of vacation pay as follows.

\[
\begin{align*}
\text{Salaries and Wages Payable} & \quad 9,600 \\
\text{Salaries and Wages Expense} & \quad 1,200 \\
\text{Cash (} & \times 20) \quad 10,800
\end{align*}
\]

**LO 3**
Current Liabilities

Bonus Agreements

Payments to certain or all employees in addition to their regular salaries or wages.

- Bonuses paid are an operating expense.
- Unpaid bonuses should be reported as a current liability.

Illustration: Palmer Inc. shows income for the year 2014 of $100,000. It will pay out bonuses of $10,700 in January 2015. Palmer makes an adjusting entry dated December 31, 2014, to record the bonuses as follows.

| Salaries and Wages Expense | 10,700 |
| Salaries and Wages Payable | 10,700 |

In 2015, Palmer records the payment of the bonus as follows.

| Salaries and Wages Payable | 10,700 |
| Cash | 10,700 |
LEARNING OBJECTIVES

After studying this chapter, you should be able to:

1. Describe the nature, type, and valuation of current liabilities.
2. Explain the classification issues of short-term debt expected to be refinanced.
3. Identify types of employee-related liabilities.
4. Identify the criteria used to account for and disclose gain and loss contingencies.
5. Explain the accounting for different types of loss contingencies.
6. Indicate how to present and analyze liabilities and contingencies.

Contingencies

“An existing condition, situation, or set of circumstances involving uncertainty as to possible gain (gain contingency) or loss (loss contingency) to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur.”

Contingencies

Gain Contingencies

Typical Gain Contingencies are:

1. Possible receipts of monies from gifts, donations, asset sales, and so on.
2. Possible refunds from the government in tax disputes.
3. Pending court cases with a probable favorable outcome.
4. Tax loss carryforwards (Chapter 19).

Gain contingencies are not recorded.
Disclosed only if probability of receipt is high.

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

1. Describe the nature, type, and valuation of current liabilities.
2. Explain the classification issues of short-term debt expected to be refinanced.
3. Identify types of employee-related liabilities.
4. Identify the criteria used to account for and disclose gain and loss contingencies.
5. Explain the accounting for different types of loss contingencies.
6. Indicate how to present and analyze liabilities and contingencies.
**Contingencies**

**Loss Contingencies**
- Involves possible losses.

**Likelihood of Loss**
FASB uses three areas of probability:
- Probable.
- Reasonably possible.
- Remote.

---

**International Perspective**
IFRS uses the term *provisions* to refer to estimated liabilities.

---

### Loss Contingencies

<table>
<thead>
<tr>
<th>Probability</th>
<th>Accounting</th>
</tr>
</thead>
<tbody>
<tr>
<td>Probable</td>
<td>Accrue</td>
</tr>
<tr>
<td>Reasonably Possible</td>
<td>Footnote</td>
</tr>
<tr>
<td>Remote</td>
<td>Ignore</td>
</tr>
</tbody>
</table>
Illustration: Scorcese Inc. is involved in a lawsuit at December 31, 2014. (a) Prepare the December 31 entry assuming it is probable that Scorcese will be liable for $900,000 as a result of this suit. (b) Prepare the December 31 entry, if any, assuming it is not probable that Scorcese will be liable for any payment as a result of this suit.

(a)  
Lawsuit Loss  900,000  
Lawsuit Liability  900,000  

(b)  
No entry is necessary. The loss is not accrued because it is not probable that a liability has been incurred at 12/31/14.
Loss Contingencies

Common loss contingencies:
1. Litigation, claims, and assessments.
2. Guarantee and warranty costs.
3. Premiums and coupons.
4. Environmental liabilities.

Loss Contingencies

Litigation, Claims, and Assessments

Companies must consider the following factors, in determining whether to record a liability with respect to pending or threatened litigation and actual or possible claims and assessments.

- **Time period** in which the action occurred.
- **Probability** of an unfavorable outcome.
- **Ability to make a reasonable estimate** of the loss.
Loss Contingencies

Guarantee and Warranty Costs
Promise made by a seller to a buyer to make good on a deficiency of quantity, quality, or performance in a product.

Cash-Basis Method.
- Expense warranty costs as incurred, because
  1. it is not probable that a liability has been incurred, or
  2. it cannot reasonably estimate the amount of the liability.

LO 5 Explain the accounting for different types of loss contingencies.

Loss Contingencies

Guarantee and Warranty Costs
Promise made by a seller to a buyer to make good on a deficiency of quantity, quality, or performance in a product.

Accrual-Basis Method.
- Charge warranty costs to operating expense in the year of sale.
  1. Method is the generally accepted method.
  2. Referred to as the expense warranty approach.
Loss Contingencies

Illustration: Denson Machinery Company begins production on a new machine in July 2014, and sells 100 units at $5,000 each by its year-end, December 31, 2014. Each machine is under warranty for one year. Denson estimates that the warranty cost will average $200 per unit. Further, as a result of parts replacements and services rendered in compliance with machinery warranties, it incurs $4,000 in warranty costs in 2014 and $16,000 in 2015.

1. Sale of 100 machines at $5,000 each, July through December 2014:
   
   | Cash or Accounts Receivable | 500,000 |
   | Sales Revenue               | 500,000 |

2. Recognition of warranty expense, July through December 2014:
   
   | Warranty Expense | 4,000 |
   | Cash, Inventory, Accrued Payroll | 4,000 |
   | Warranty Expense | 16,000 |
   | Warranty Liability | 16,000 |

3. Recognition of warranty costs incurred in 2015 (on 2014 sales):
   
   | Warranty Liability | 16,000 |
   | Cash, Inventory, Accrued Payroll | 16,000 |

LO 5 Explain the accounting for different types of loss contingencies.
Loss Contingencies

Premiums and Coupons

Companies should charge the costs of premiums and coupons to expense in the period of the sale that benefits from the plan.

- Company estimates the number of outstanding premium offers that customers will present for redemption.
- Company charges the cost of premium offers to Premium Expense and credits Premium Liability.

Illustration: Fluffy Cakemix Company offered its customers a large, nonbreakable mixing bowl in exchange for 25 cents and 10 boxtops. The mixing bowl costs Fluffy Cakemix Company 75 cents, and the company estimates that customers will redeem 60 percent of the boxtops. The premium offer began in June 2014 and resulted in the transactions journalized below. Fluffy Cakemix Company records purchase of 20,000 mixing bowls as follows.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory of Premiums</td>
<td>15,000</td>
</tr>
<tr>
<td>Cash</td>
<td>15,000</td>
</tr>
</tbody>
</table>

$20,000 x .75 = $15,000
Loss Contingencies

Illustration: The entry to record sales of 300,000 boxes of cake mix would be:

Cash \[300,000 \times .80 = $240,000\]

Sales Revenue \[240,000\]

Fluffy records the actual redemption of 60,000 box tops, the receipt of 25 cents per 10 box tops, and the delivery of the mixing bowls as follows.

Cash \[(60,000 \div 10) \times 0.25\] \[1,500\]

Premium Expense \[3,000\]

Inventory of Premiums \[4,500\]

Computation: \((60,000 \div 10) \times 0.75 = 4,500\)

Loss Contingencies

Illustration: Finally, Fluffy makes an end-of-period adjusting entry for estimated liability for outstanding premium offers (box tops) as follows.

Premium Expense \[6,000\]

Premium Liability \[6,000\]

Computation:

<table>
<thead>
<tr>
<th>Total box tops sold in 2014</th>
<th>300,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total estimated redemptions (60%)</td>
<td>180,000</td>
</tr>
<tr>
<td>Box tops redeemed in 2014</td>
<td>60,000</td>
</tr>
<tr>
<td>Estimated future redemptions</td>
<td>120,000</td>
</tr>
<tr>
<td>Cost of estimated claims outstanding</td>
<td>((120,000 \div 10) \times (0.75 - 0.25) = 6,000)</td>
</tr>
</tbody>
</table>

LO 5 Explain the accounting for different types of loss contingencies.
Numerous companies offer premiums to customers in the form of a promise of future goods or services as an incentive for purchases today. Premium plans that have widespread adoption are the frequent-flyer programs used by all major airlines. On the basis of mileage accumulated, frequent-flyer members receive discounted or free airline tickets. Airline customers can earn miles toward free travel by making long-distance phone calls, staying in hotels, and charging gasoline and groceries on a credit card. Those free tickets represent an enormous potential liability because people using them may displace paying passengers.

When airlines first started offering frequent-flyer bonuses, everyone assumed that they could accommodate the free-ticket holders with otherwise-empty seats. That made the additional cost of the program so minimal that airlines didn’t accrue it or report the small liability. But, as more and more paying passengers have been crowded off flights by frequent-flyer awardees, the loss of revenues has grown enormously. For example, United Continental Holdings at one time reported a liability of $2.4 billion for frequent-flyer tickets.

Although the profession has studied the accounting for this transaction, no authoritative guidelines have been issued.

Loss Contingencies

Environmental Liabilities

A company must recognize an asset retirement obligation (ARO) when it has an existing legal obligation associated with the retirement of a long-lived asset and when it can reasonably estimate the amount of the liability.

ARO’s should be recorded as fair value.
Loss Contingencies

Environmental Liabilities

**Obligating Events.** Examples of existing legal obligations, which require recognition of a liability include, but are not limited to:

- Decommissioning nuclear facilities;
- Dismantling, restoring, and reclamation of oil and gas properties;
- Certain closure, reclamation, and removal costs of mining facilities;
- Closure and post-closure costs of landfills.

**Illustration:** On January 1, 2014, Wildcat Oil Company erected an oil platform in the Gulf of Mexico. Wildcat is legally required to dismantle and remove the platform at the end of its useful life, estimated to be five years. Wildcat estimates that dismantling and removal will cost $1,000,000. Based on a 10 percent discount rate, the fair value of the asset retirement obligation is estimated to be $620,920 ($1,000,000 x .62092). Wildcat records this ARO as follows.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Drilling Platform</td>
<td>620,920</td>
</tr>
<tr>
<td>Asset Retirement Obligation</td>
<td>620,920</td>
</tr>
</tbody>
</table>

Lo 5 Explain the accounting for different types of loss contingencies.
**Loss Contingencies**

**Illustration:** During the life of the asset, Wildcat allocates the asset retirement cost to expense. Using the straight-line method, Wildcat makes the following entries to record this expense.

**December 31, 2014 through 2018**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciation Expense (($620,920 \div 5))</td>
<td>124,184</td>
</tr>
<tr>
<td>Accumulated Depreciation</td>
<td>124,184</td>
</tr>
</tbody>
</table>

**Loss Contingencies**

**Illustration:** In addition, Wildcat must accrue interest expense each period. Wildcat records interest expense and the related increase in the asset retirement obligation on December 31, 2014, as follows.

**December 31, 2014**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest Expense (($620,092 \times 10%))</td>
<td>62,092</td>
</tr>
<tr>
<td>Asset Retirement Obligation</td>
<td>62,092</td>
</tr>
</tbody>
</table>
Loss Contingencies

Illustration: On January 10, 2019, Wildcat contracts with Rig Reclaimers, Inc. to dismantle the platform at a contract price of $995,000. Wildcat makes the following journal entry to record settlement of the ARO.

January 10, 2019

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset Retirement Obligation</td>
<td>1,000,000</td>
<td></td>
</tr>
<tr>
<td>Gain on Settlement of ARO</td>
<td></td>
<td>5,000</td>
</tr>
<tr>
<td>Cash</td>
<td></td>
<td>995,000</td>
</tr>
</tbody>
</table>

Loss Contingencies

Self-Insurance

Self-insurance is not insurance, but risk assumption.

There is little theoretical justification for the establishment of a liability based on a hypothetical charge to insurance expense.

Notes to Financial Statements (in part)

Note 21: Insurance. We are self-insured for certain insurable risks consisting primarily of employee health insurance programs, as well as workers’ compensation, general liability, automobile liability, and property insurance deductibles and retentions. We fully insured future risks for long-term disability, and, in most states, workers’ compensation, but maintained a self-insured position for workers’ compensation for certain self-insured states and for claims incurred prior to the inception of the insurance coverage in Colorado in 1997.
1. Describe the nature, type, and valuation of current liabilities.
2. Explain the classification issues of short-term debt expected to be refinanced.
3. Identify types of employee-related liabilities.
4. Identify the criteria used to account for and disclose gain and loss contingencies.
5. Explain the accounting for different types of loss contingencies.
6. Indicate how to present and analyze liabilities and contingencies.

Presentation and Analysis

Presentation of Current Liabilities

- Usually reported at their full maturity value.
- Difference between present value and the maturity value is considered immaterial.
- Companies may list the accounts in
  - Order of maturity,
  - Descending order of amount, or
  - Order of liquidation preference.

LO 6 Indicate how to present and analyze liabilities and contingencies.
Presentation and Analysis

Illustration 13-13

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>(dollars in thousands)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash and cash equivalents</td>
<td>$1,199</td>
<td>$1,103</td>
</tr>
<tr>
<td>Short-term investments</td>
<td>-</td>
<td>22</td>
</tr>
<tr>
<td>Receivables</td>
<td>2,288</td>
<td>2,348</td>
</tr>
<tr>
<td>Merchandise inventories</td>
<td>5,731</td>
<td>5,697</td>
</tr>
<tr>
<td>Other current assets</td>
<td>1,079</td>
<td>1,103</td>
</tr>
<tr>
<td>Total current assets</td>
<td>$10,297</td>
<td>$10,473</td>
</tr>
<tr>
<td>Current liabilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts payable</td>
<td>$5,564</td>
<td>$4,894</td>
</tr>
<tr>
<td>Unredeemed gift card liabilities</td>
<td>456</td>
<td>474</td>
</tr>
<tr>
<td>Accrued compensation and related expenses</td>
<td>539</td>
<td>570</td>
</tr>
<tr>
<td>Accrued liabilities</td>
<td>1,685</td>
<td>1,471</td>
</tr>
<tr>
<td>Accrued income taxes</td>
<td>288</td>
<td>256</td>
</tr>
<tr>
<td>Short-term debt</td>
<td>480</td>
<td>557</td>
</tr>
<tr>
<td>Current portion of long-term debt</td>
<td>43</td>
<td>441</td>
</tr>
<tr>
<td>Total current liabilities</td>
<td>$8,855</td>
<td>$8,663</td>
</tr>
</tbody>
</table>

Presentation and Analysis

Presentation of Current Liabilities

If a company excludes a short-term obligation from current liabilities because of refinancing, it should include the following in the note to the financial statements:

1. A general description of the financing agreement.
2. The terms of any new obligation incurred or to be incurred.
3. The terms of any equity security issued or to be issued.

LO 6 Indicate how to present and analyze liabilities and contingencies.
Presentation and Analysis

Presentation of Current Liabilities

Actual Refinancing of Short-Term Debt

<table>
<thead>
<tr>
<th>December 31, 2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current liabilities</td>
</tr>
<tr>
<td>Accounts payable</td>
</tr>
<tr>
<td>Accrued payables</td>
</tr>
<tr>
<td>Income taxes payable</td>
</tr>
<tr>
<td>Current portion of long-term debt</td>
</tr>
<tr>
<td><strong>Total current liabilities</strong></td>
</tr>
<tr>
<td>Long-term debt</td>
</tr>
<tr>
<td>Notes payable refinanced in January 2015</td>
</tr>
<tr>
<td>11% bonds due serially through 2025</td>
</tr>
<tr>
<td><strong>Total long-term debt</strong></td>
</tr>
</tbody>
</table>

Note 1: On January 19, 2015, the Company issued 50,000 shares of common stock and received proceeds totaling $2,385,000, of which $2,000,000 was used to liquidate notes payable that matured on February 1, 2015. Accordingly, such notes payable have been classified as long-term debt at December 31, 2014.

LO 6  Indicate how to present and analyze liabilities and contingencies.

Presentation and Analysis

Presentation of Contingencies

Disclosure should include:

- Nature of the contingency.
- An estimate of the possible loss or range of loss or a statement that an estimate cannot be made.

Companies should disclose certain other contingent liabilities.

1. Guarantees of indebtedness of others.
2. Obligations of commercial banks under “stand-by letters of credit.”
3. Guarantees to repurchase receivables (or any related property) that have been sold or assigned.

LO 6
Disclosure of Loss Contingency through Litigation

Raymark Corporation

Note: Litigation. Raymark is a defendant or co-defendant in a substantial number of lawsuits alleging wrongful injury and/or death from exposure to asbestos fibers in the air. The following table summarizes the activity in these lawsuits:

- Claims
  - Pending at beginning of year: 8,719
  - Received during year: 4,494
  - Settled or otherwise disposed of: (1,445)
  - Pending at end of year: 11,766
- Average indemnification cost: $3,364
- Average cost per case, including defense costs: $6,499
- Trial activity:
  - Verdicts for the Company: 23
- Total trial: 36

The following table presents the cost of defending asbestos litigation, together with related insurance and workers’ compensation expenses:

- Included in operating profit: $1,872,000
- Nonoperating expense: 9,077,000
- Total: $10,949,000

The company is seeking to reasonably determine its liability. However, it is not possible to predict which theory of insurance will apply, the number of lawsuits still to be filed, the cost of settling and defending the existing and unfounded cases, or the ultimate impact of these lawsuits on the company’s consolidated financial statements.

Analysis of Current Liabilities

Two ratios to help assess liquidity are:

- Current ratio = \( \frac{\text{Current assets}}{\text{Current liabilities}} \)
- Acid-test ratio = \( \frac{\text{Cash} + \text{Short-term investments} + \text{Net receivables}}{\text{Current liabilities}} \)
RELEVANT FACTS - Similarities

- Similar to U.S. practice, IFRS requires that companies present current and non-current liabilities on the face of the statement of financial position (balance sheet), with current liabilities generally presented in order of liquidity. However, many companies using IFRS present non-current liabilities before current liabilities on the statement of financial position.

The basic definition of a liability under GAAP and IFRS is very similar. In a more technical way, liabilities are defined by the IASB as a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. Liabilities may be legally enforceable via a contract or law but need not be. That is, they can arise due to normal business practices or customs.

- IFRS requires that companies classify liabilities as current or non-current on the face of the statement of financial position (balance sheet), except in industries where a presentation based on liquidity would be considered to provide more useful information (such as financial institutions).
IFRS INSIGHTS

RELEVANT FACTS - Differences

♦ Under IFRS, the measurement of a provision related to a contingency is based on the best estimate of the expenditure required to settle the obligation. If a range of estimates is predicted and no amount in the range is more likely than any other amount in the range, the “midpoint” of the range is used to measure the liability. In GAAP, the minimum amount in a range is used.

♦ Both IFRS and GAAP prohibit the recognition of liabilities for future losses. However, IFRS permits recognition of a restructuring liability, once a company has committed to a restructuring plan. GAAP has additional criteria (i.e., related to communicating the plan to employees) before a restructuring liability can be established.

LO 7 Compare the accounting procedures for current liabilities and contingencies under GAAP and IFRS.

IFRS INSIGHTS

RELEVANT FACTS - Differences

♦ IFRS and GAAP are similar in the treatment of asset retirement obligations (AROs). However, the recognition criteria for an ARO are more stringent under GAAP: The ARO is not recognized unless there is a present legal obligation and the fair value of the obligation can be reasonably estimated.

♦ Under IFRS, short-term obligations expected to be refinanced can be classified as non-current if the refinancing is completed by the financial statement date. GAAP uses the date the financial statements are issued.

LO 7 Compare the accounting procedures for current liabilities and contingencies under GAAP and IFRS.
RELEVANT FACTS - Differences

- IFRS uses the term provisions to refer to estimated liabilities. Under IFRS, contingencies are not recorded but are often disclosed. The accounting for provisions under IFRS and estimated liabilities under GAAP are very similar.

- GAAP uses the term contingency in a different way than IFRS. Contingent liabilities are not recognized in the financial statements under IFRS, whereas under GAAP, a contingent liability is sometimes recognized.

IFRS SELF-TEST QUESTION

Under IFRS, a provision is the same as:

a. a contingent liability.

b. an estimated liability.

c. a contingent gain.

d. None of the above.
IFRS SELF-TEST QUESTION

A typical provision is:

a. bonds payable.
b. cash.
c. a warranty liability.
d. accounts payable.

LO 7 Compare the accounting procedures for current liabilities and contingencies under GAAP and IFRS.

IFRS SELF-TEST QUESTION

In determining the amount of a provision, a company using IFRS should generally measure:

a. using the midpoint of the range between the lowest possible loss and the highest possible loss.
b. using the minimum amount of the loss in the range.
c. using the best estimate of the amount of the loss expected to occur.
d. using the maximum amount of the loss in the range.

LO 7 Compare the accounting procedures for current liabilities and contingencies under GAAP and IFRS.
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