CHAPTER 13

Current Liabilities and Contingencies
LECTURE OUTLINE

This chapter can be covered in two or three class sessions. Students should be familiar with trade and payroll liabilities. Short-term obligations expected to be refinanced and the accounting for loss contingencies are the conceptually challenging areas for many students.

Section 1—Current Liabilities

A. The Concept of Liabilities.

1. The question of what is a liability is not a simple issue to resolve. This can be seen if the example of preferred stock is analyzed.

2. In SFAC No. 6, 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."

B. Current Liabilities.

1. Nature of current liabilities: Obligations whose liquidation is reasonably expected to require the use of existing resources classified as current assets, or the creation of other current liabilities.

2. Current liabilities can be classified as either determinable or contingent.

C. Determinable Current Liabilities: Such liabilities can be measured with a fair degree of precision and the amount and timing of the cash outflows are reasonably certain.
1. Accounts Payable.

2. Notes Payable.
   
a. Trade notes.

b. Short-term loan notes: Such notes represent a current liability and generally are the result of cash loans. The notes may be interest bearing or zero-interest bearing.

   (1) Interest bearing notes: the borrower receives the face value of the note and records the note at face value.

   (2) Zero-interest bearing notes: the borrower receives an amount equal to the face value of the note less the interest. The note is recorded at its face value and the "prepaid" interest is recorded in a Discount on Notes Payable account.

c. Current maturities of long-term debt: That portion of long-term debt that matures within the next fiscal year is reported as a current liability, unless it is to be refinanced by a new debt issue or by conversion into stock.

3. Short-term obligations expected to be refinanced.

   **TEACHING TIP**

   Illustration 13-1 can be used to discuss the requirements of SFAS No. 6, "Classification of Short term Obligations Expected to be Refinanced."

   a. Can be excluded from current liabilities only if the firm:

      (1) **Intends** to refinance, and

      (2) Demonstrates an **ability** to refinance.

   b. Ability can be evidenced by:

      (1) **Actual refinancing**, or
(2) **Signing a refinancing agreement** (with a **capable lender**) which is **noncancellable** and **not violated**.

c. Amount excluded cannot exceed amount available under agreement.

d. Refinancing must occur before current debt is due.

4. **Dividends Payable**: At the date of declaration of a **cash dividend**, the corporation assumes a liability. **Preferred dividends in arrears** are not a legal obligation until a distribution is formally authorized. **Stock dividends** are part of stockholders’ equity (not a liability).

5. Returnable deposits.

6. Unearned Revenues.

7. Sales taxes payable.

8. Property taxes payable: the accounting questions are:
   a. When should the liability be recorded?
   b. Which accounting period should be charged with the cost?

9. Income taxes payable
   a. Sole proprietorships and partnerships are not taxable entities.
   b. Interim tax payments are based on estimates of the total annual tax liability.

10. Employee-related liabilities
   a. Payroll deductions
(a) Paid by both the employee and employer.

(b) 7.65% on wages up to $65,400 and 1.45% on wages in excess of this amount.

(2) Unemployment taxes: paid by the employer

(a) F.U.T.A. is 0.8% on the first $7,000 of each employee.

(b) S.U.T.A. is 5.4% on the same amount.

(3) Income tax withholding: federal and state income taxes on employee earnings.

b. **Compensated absences:** Vacations, illnesses, and holidays for which employees are normally paid. SFAS 43 requires a liability has to be accrued for future absences if all the following conditions are met:

(1) The obligation arises from services already rendered by the employee.

(2) The rights vest or accumulate.

   (a) **Vested rights:** an obligation to pay employee exists even if employment is terminated.

   (b) **Accumulated rights:** can be carried forward to future periods if not used in the period earned.

(3) Payment is probable.

(4) The amount can be reasonably estimated.

c. **Postretirement benefits:** pertains to pensions and postretirement health care and life insurance benefits. Covered in Chapter 21.
d. **Bonus arrangements:** usually considered additional wages. Covered in Appendix 13-A.

**Section 2—Contingencies**

A. **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.

1. **Gain contingencies:** are not recorded and are only disclosed when the probability is high that it will become a reality.

2. **Loss contingencies:** result in recognition of a contingent liability.

B. **Contingent Liabilities:** Liabilities which are dependent upon the occurrence or nonoccurrence of one or more future events to confirm either the amount payable, or the payee, or the date payable, or its existence. The condition had to exist at the balance sheet date. Information has to be available prior to issuing financial statements.

**TEACHING TIP**

Use *Illustration 13-2* to discuss the probability concepts of probable, reasonably possible, and remote in the context of loss contingencies.

1. The likelihood that the future event or events will confirm the incurrence of a liability can be classified as:

   a. **Probable.** The future event or events are likely to occur. A liability is recorded if the information indicates that it is probable that a liability had been incurred at the balance sheet date and the amount of the loss can be reasonably estimated.

   b. **Reasonably possible.** The chance of the future event or events occurring is more than remote but less than likely.
c. **Remote.** The chance of the future event or events occurring is slight.

2. Accrual of a loss contingency should be made if **both** of the following conditions are met:
   
a. It is **probable that a liability has been incurred** at the date of the financial statements.
   
b. The amount of the loss can be **reasonably estimated**.

3. **Common loss contingencies**
   
a. **Litigation, claims, and assessments.** The following factors should be considered.
      
      (1) The period in which the underlying cause for action occurred.
      
      (2) The degree of probability of an unfavorable outcome.
      
      (3) The ability to make a reasonable estimate of the amount of the loss.
   
b. **Guarantee and warranty costs:** The amount of the liability is an estimate of all the costs that will be incurred after sale and delivery.
      
      (1) Cash basis method.
      
      (2) Accrual methods.
         
         (a) **Expense warranty treatment.** This method should be used whenever the warranty is an integral and inseparable part of the product sale and requires warranty costs to be charged to operating expense in the year of sale.
         
         (b) **Sales warranty treatment.** This method is used when the warranty is sold separately from the product and requires that revenues from the sale of the warranty be deferred and subsequently recognized as income over the life of the warranty contract.
c. **Premiums and coupons offered to customers:** Result in the probable existence of a liability at the date of the financial statements.

d. **Environmental liabilities.** Companies rarely record potential environmental costs as liabilities generally noting that they are contingent liabilities that are not estimatable.

e. **Self-insurance.** The absence of insurance does not mean that a liability has been incurred at the date of the financial statements.

   (1) Accrual is recessing only if uninsured losses resulting from injury to others or damage to other’s property took place prior to the financial statement date and a reasonable estimate of the amount can be made.

<table>
<thead>
<tr>
<th>TEACHING TIP</th>
</tr>
</thead>
<tbody>
<tr>
<td>The accounting treatment of loss contingencies can be summarized with the aid of Illustration 13-3.</td>
</tr>
</tbody>
</table>

**Section 3—Presentation and Analysis**

A. Presentation of current liabilities

   1. Owing to their short-term nature current liabilities are reported at their full maturity value, not their present value.

   2. The current liability accounts are generally the first classification in the liability section of the balance sheet.

   3. Current liabilities are frequently listed in order of maturity, according to amount, or in order of liquidation preference.

   4. Disclosures for short-term obligations expected to be refinanced should include:

      a. A general description of the financing agreement.

      b. The terms of any new obligations incurred or to be incurred.
c. The terms of any equity security issued or to be issued.

5. Currently maturing debt to be paid with noncurrent assets should be classified as long-term liabilities.

6. Secured liabilities should be identified and the related assets clearly indicated.

B. Presentation of contingencies.

1. If a loss contingency is either probable or estimatable but not both and if there is at least a reasonable possibility that a liability may have been incurred, the following disclosure is required:

   a. The nature of the contingency.
   
   b. An estimate of the possible loss or range of loss or a statement that an estimate cannot be made.

2. Other contingent liabilities that should be disclosed even if the possibility of a loss is remote are:

   a. Guarantees of indebtedness to others.
   
   b. Obligations to banks under "stand-by letters of credit".
   
   c. Guarantees to repurchase receivables (or any related property) that have been sold or assigned.

3. Disclosure should include the nature and amount of the guarantee and, if estimable, the amount to be recovered from outside parties.

C. Analysis of current liabilities.

1. Current ratio = \( \frac{\text{current assets}}{\text{current liabilities}} \)

2. Acid-test ratio = \( \frac{\text{cash} + \text{marketable securities} + \text{net receivables}}{\text{current liabilities}} \)
APPENDIX 13-A. Computation of Employees’ Bonuses

A. Employee bonuses are an expense, and are usually based on net income.

B. Bonus calculation under differing arrangements.

1. When the bonus is based on **income after the bonus, but before taxes**.
   
   Bonus = Bonus % x (Income before bonus – Bonus)

2. When the bonus is based on **income after taxes, but before the bonus**.
   
   Bonus = Bonus % x (Income before bonus – Taxes)
   
   Taxes = Tax rate x (Income before bonus – Bonus)

3. When the bonus is based on **income after both the bonus and taxes**.
   
   Bonus = Bonus % x (Income before bonus – Bonus– Taxes)
   
   Taxes = Tax rate x (Income before bonus – Bonus)