

Financial Accounting

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MGM611

Lecture (10) **Current Liabilities**



Current Liabilities

Chapter Outline

Learning Objectives

- LO 1** Explain how to account for current liabilities.
- LO 2** Discuss how current liabilities are reported and analyzed.

Accounting for Current Liabilities

What is a Current Liability?

A debt that a

- company expects to pay within one year **or**
- the operating cycle, whichever is longer.

Current liabilities include **notes payable, accounts payable, unearned revenues, and accrued liabilities** such as **taxes payable, salaries and wages payable, and interest payable.**

Accounting for Current Liabilities

To be classified as a current liability, a debt must be expected to be paid within:

- a. one year
- b. the operating cycle
- c. 2 years
-  d. (a) or (b), whichever is longer

Accounting for Current Liabilities

Notes Payable

- Written **promissory** note
- Frequently issued to meet short-term financing needs
- Requires borrower to pay interest
- Issued for varying periods

Notes Payable

Illustration: First Hunan Bank agrees to lend ¥100,000 on September 1, 2020, if Yang Enterprises signs a ¥100,000, 12%, four-month note maturing on January 1 (amounts in thousands). When a company issues an interest-bearing note, the amount of assets it receives upon issuance of the note generally equals the note's face value which is equal ¥100,000 the journal entry to record the issuance of notes will be.

Sept. 1	Cash	100,000	
	Notes Payable		100,000

Notes Payable

Illustration: If Yang prepares financial statements annually, it makes an adjusting entry at **December 31** to recognize interest expense and interest payable. Compute the interest for the **four months** ended December 31, 2020.

$$¥100,000 \times 12\% \times 4/12 = \text{¥4,000}$$

Yang makes an adjusting entry as follows.

Dec. 31	Interest Expense	4,000	
	Interest Payable		4,000

Notes Payable

Illustration: At maturity (January 1, 2021), Yang must pay the face value of the note **plus** interest. It records payment of the **note and accrued interest as follows.**

Jan. 1	Notes Payable	100,000	
	Interest Payable	4,000	
	Cash		104,000

Accounting for Current Liabilities

Sales Taxes Payable (Liability)

- Sales taxes are expressed as a stated percentage of sales price
- Selling company (retailer)
 - collects tax from customer
 - enters tax separately in cash register or includes in total receipts
 - remits the collections to state's department of revenue

Sales Taxes Payable

Illustration: The March 25 cash register reading for Cooley Grocery shows sales of €10,000 and sales taxes of €600 (sales tax rate of 6%), the journal entry is:

Mar. 25	Cash	10,600	
	Sales Revenue		10,000
	Sales Taxes Payable		600

Sales Taxes Payable

Sometimes companies do not enter sales taxes separately in the cash register. If Cooley Grocery enters **total receipts** of €10,600. Because the amount received from the sale is equal to the sales price 100% **plus 6%** of sales, we compute the sales amount as follows:

$$€10,600 \div 1.06 = \mathbf{€10,000}$$

$$\mathbf{Or} \ 10600 * (106/100)$$

The journal entry is:

Mar. 25	Cash	10,600	
	Sales Revenue		10,000
	Sales Taxes Payable		600

DO IT! 1 | Current Liabilities

How is the sales tax amount determined when the cash register total includes sales taxes?

Solution

First, divide the total cash register receipts by 100% plus the sales tax percentage to find the sales revenue amount.

Second, subtract the sales revenue amount from the total cash register receipts to determine the sales taxes.

Accounting for Current Liabilities

Unearned Revenues

Revenues received from customers **before** the company

- **delivers** goods or
- **provides** services.

Type of Business	Account Title	
	Unearned Revenue	Revenue
Airline	Unearned Ticket Revenue	Ticket Revenue
Magazine publisher	Unearned Subscription Revenue	Subscription Revenue
Hotel	Unearned Rent Revenue	Rent Revenue

Unearned Revenue

Illustration: Liverpool F.C. sells 10,000 season soccer (football) tickets at £50 each for **its five-game home schedule**. The entry for the sale of season tickets is:

Aug. 6	Cash (10,000 x £50)	500,000	
	Unearned Ticket Revenue		500,000

As each game is completed, Liverpool records the recognition of revenue with the following entry:

Sept. 7	Unearned Ticket Revenue	100,000	
	Ticket Revenue		100,000

Accounting for Current Liabilities

Current Maturities of Long-Term Debt

- Portion of debt that comes due in current year
- No adjusting entry required

Illustration: Wendy Construction issues a **five-year**, interest-bearing **€25,000** note on **January 1, 2020**. This note specifies that each January 1, starting January 1, 2021, Wendy should pay **€5,000** of the note. When the company prepares financial statements on **December 31, 2020**,

1. Amount to be reported as a current liability? **€5,000**
2. Amount to be reported as a non-current liability? **€20,000**

DO IT! 1 | Current Liabilities

You and several classmates are studying for the next accounting examination. They ask you to answer the following questions (amounts in thousands).

1. If cash is borrowed on a HK\$50,000, 6-month, 12% note on **September 1**, how much interest expense would be incurred by **December 31**?

Solution

$$\text{HK\$50,000} \times 12\% \times 4/12 = \text{HK\$2,000}$$

DO IT! 1 | Current Liabilities

You and several classmates are studying for the next accounting examination. They ask you to answer the following questions (amounts in thousands).

3. If HK\$15,000 is collected in advance on **November 1** for 3 months' rent, what amount of **rent revenue** should be recognized by **December 31**?

Solution

$$\text{HK\$15,000} \times \frac{2}{3} = \text{HK\$10,000}$$

Reporting and Analyzing Current Liabilities

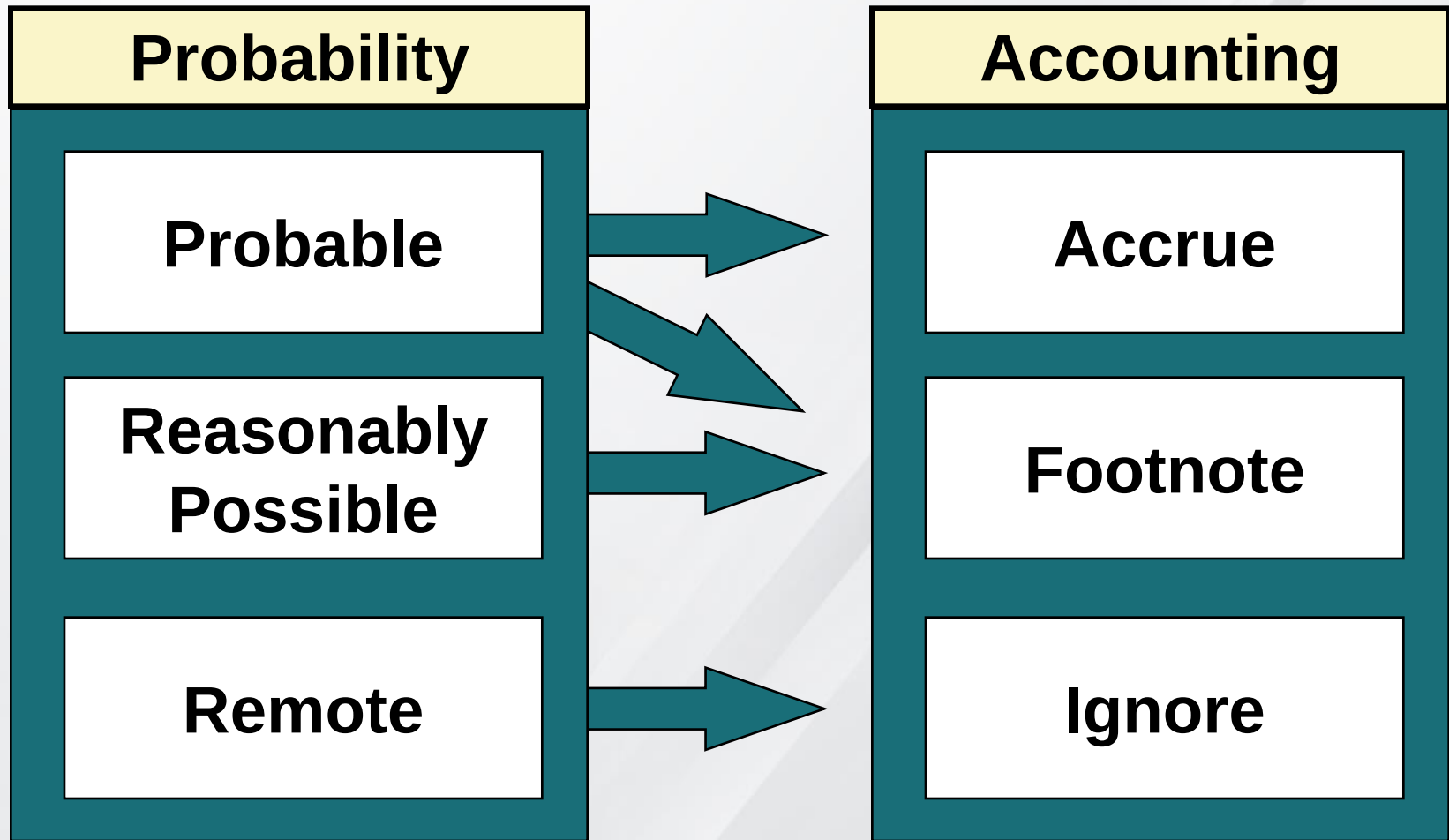
Reporting Uncertainty

Provision - Potential liability that may become an actual liability in the future (**uncertain timing or amount**).

Three levels of probability:

- Probable
- Reasonably possible
- Remote

Reporting a Provision



Reporting a Provision

A provision should be recorded in the accounts when:

- a. it is probable the cash outflow will happen, but the amount cannot be reliably estimated.
- b. it is possible the cash outflow will happen, and the amount can be reliably estimated.
- ➡ c. it is probable the cash outflow will happen, and the amount can be reliably estimated.
- d. it is possible the contingency will happen, but the amount cannot be reasonably estimated.

Reporting a Provision

Product Warranties

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

Estimated cost of honoring product warranty contracts should be recognized as an **expense in the period** in which the sale occurs.

Analysis of Current Liabilities

**Croix
Beverages**

Liquidity refers to the ability to pay maturing obligations and meet unexpected needs for cash.

ILLUSTRATION 11.6

Current Assets	-	Current Liabilities	=	Working Capital
€20,856	-	€16,210	=	€4,646

Current ratio permits us to compare liquidity of different-sized companies and of a single company at different times.

Current Assets	÷	Current Liabilities	=	Current Ratio
€20,856	÷	€16,210	=	1.29:1

ILLUSTRATION 11.7

DO IT! 2 | Reporting and Analyzing

Tron Cellular has the following account balances at December 31, 2020.

Notes payable (NT\$80,000 due after 12/31/21)	NT\$200,000
Unearned service revenue	75,000
Other long-term debt (NT\$30,000 due in 2021)	150,000
Salaries and wages payable	22,000
Other accrued expenses	15,000
Accounts payable	100,000

In addition, Tron is involved in a lawsuit. Legal counsel feels it is probable Tron will pay damages of NT\$38,000 in 2021.

- Prepare the current liabilities section of Tron's December 31, 2020, statement of financial position.
- Tron's current assets are NT\$504,000. Compute Tron's working capital and current ratio.

DO IT! 2 | Reporting and Analyzing

- a. Prepare the current liabilities section of Tron's December 31, 2020, statement of financial position.

Current liabilities	
Total current liabilities	

DO IT! 2 Reporting and Analyzing

- b. Tron's current assets are NT\$504,000. Compute Tron's working capital and current ratio.

Working capital = Current assets – Current liabilities =

$$\text{NT\$504,000} - \text{NT\$400,000} = \mathbf{\text{NT\$104,000}}$$

Current ratio = Current assets ÷ Current liabilities =

$$\text{NT\$504,000} \div \text{NT\$400,000} = \mathbf{1.26:1}$$

Accounting for Payroll

“Payroll” pertains to both:

Salaries - managerial, administrative, and sales personnel (monthly or yearly rate).

Wages - store clerks, factory employees, and manual laborers (rate per hour).

Determining the Payroll

Involves computing three amounts: (1) **gross earnings**, (2) **payroll deductions**, and (3) **net pay**.

Determining the Payroll

Gross Earnings

Total compensation earned by an employee (wages or salaries, plus any bonuses and commissions).

<u>Type of Pay</u>	<u>Hours</u>	<u>x</u>	<u>Rate</u>	<u>=</u>	<u>Gross Earnings</u>
Regular	40		\$12		\$480
Overtime	4		18		72
Total wages					\$552

Payroll Deductions

- Most common types of payroll deductions: taxes, insurance premiums, employee savings, union dues
- To the extent that a company has not remitted the amounts deducted to the proper authority at the end of the accounting period, it should recognize them as current liabilities

1. Notes payable usually require the borrower to pay interest.

Answer: True

2. Interest expense on a note payable is only recorded at maturity.

Answer: False

3. The higher the sales tax rate, the more profit a retailer can earn.

Answer: False

4. Notes payable usually are issued to meet long-term financing needs.

Answer: False

5. Companies often identify current maturities of long-term debt on the statement of financial position as long-term debt due within one year.

Answer: True

A note payable is in the form of

- a. a contingency that is reasonably likely to occur.
- b. a written promissory note.
- c. an oral agreement.
- d. a large agreement.

Answer: B

As interest is recorded on an interest-bearing note, the Interest Expense account is

- a. increased; the Notes Payable account is increased.
- b. increased; the Notes Payable account is decreased.
- c. increased; the Interest Payable account is increased.
- d. decreased; the Interest Payable account is increased.

Answer: C

A Company has total proceeds from sales of \$9,540 (Including sales tax) . If the sales tax is 6%, the amount to be credited to the account Sales Revenue is:

- a. \$9,540.
- b. \$8,968.
- c. \$10,112.
- d. \$9,000.

Answer: D

Thank You