CHAPTER 13

Current Liabilities and Contingencies

OBJECTIVES

After reading this chapter, you will be able to:

1. Explain the characteristics of a liability.
2. Define current liabilities.
3. Account for compensated absences.
4. Understand and record payroll taxes and deductions.
5. Record property taxes.
6. Account for warranty costs.
7. Explain the terms “probable,” “reasonably possible,” and “remote” related to contingencies.
8. Record and report a loss contingency.
9. Disclose a gain contingency.
Conceptual Overview of Liabilities

1. In its Conceptual Framework, the FASB defined liabilities as probable future sacrifices of economic benefits arising from present obligations of a company to transfer assets or provide services to other entities in the future as a result of past transactions or events.

2. Liabilities include both legal and nonlegal (but not illegal) obligations. Legal liabilities, such as accounts payable, notes payable, and sales taxes payable, arise from contractual transactions. Consequently, the company is legally required to pay cash or provide goods or services. With nonlegal liabilities (accounting liabilities), payments are expected as part of the company's normal operations, even though they are not legally required.

3. There are three essential characteristics of a liability for a company:
   (a) A liability involves a present obligation that will be settled by a probable future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand.
   (b) The obligated company is left little or no discretion to avoid the future sacrifice.
   (c) The transaction or other event obligating the company has already happened.

4. Two other points are made about liabilities:
   (a) The obligated company does not need to know the identity of the recipient to record a liability, as long as a transfer of assets to settle an existing obligation is probable.
   (b) If the company has a duty or responsibility to pay cash, transfer assets, or provide services, the obligation need not be legally enforceable to qualify as a liability.

Nature and Definition of Current Liabilities

5. Current liabilities are obligations whose liquidation is expected to require the use of existing current assets or the creation of other current liabilities within one year or an operating cycle, whichever is longer. An operating cycle is the time normally required for a company to convert cash into inventory, sell the inventory, and collect the resulting receivables.

6. Information about liquidity (how quickly a liability can be paid, or its nearness to cash) is important to users because in part the prediction of future cash flows is based on the nearness to cash of liabilities and assets. The FASB discussed alternative methods of reporting liquidity and examined useful liquidity ratios. The AICPA Special Committee on Financial Reporting stated that a company should identify internal and external sources of liquidity and significant unused sources of liquid assets in its Management Discussion and Analysis (MD&A) section of their annual report.

7. Financial flexibility refers to a company's ability to use its financial resources to adapt to change. Financial flexibility primarily involves the management of cash and other resources. In addition, it includes the potential to create new current and long-term liabilities, to restructure existing debt, and to manage debt in other ways.
8. The primary types of current liabilities are classified into three groups in the text: (a) current liabilities having a contractual amount; (b) current liabilities whose amounts depend on operations; and (c) current liabilities that require amounts to be estimated.

Valuation of Current Liabilities

9. Conceptually, a company should record all liabilities at the present value of the future outlays they will require, and should disclose the liabilities in a way that provides useful information about their liquidity. However, most current liabilities are measured, recorded, and reported at their maturity or face value. Usually the difference between maturity value and present value is not material.

Current Liabilities Having a Contractual Amount

10. Because of the terms of contracts or the existence of laws, the amount and maturity of some current liabilities are known with reasonable certainty. Examples include trade accounts payable, notes payable, currently maturing portions of long-term debt, dividends payable, advances and refundable deposits, accrued liabilities, and unearned items.

11. Trade accounts payable arise from the purchase of inventory, supplies, or services on an open charge-account basis. The amount to be recorded is based on the invoice received from the creditor. Companies record liabilities in two ways: using the gross price method (at the invoice price) or using the net price method (at the invoice price less the cash discount). Care must be taken that end-of-year purchases and liabilities are recorded in the proper accounting period, when economic control of (and legal title to) the goods passes.

12. A note payable, which may be either long-term or short-term, is an unconditional written agreement to pay a sum of money to the bearer on a specific date. The interest for a note payable may be either stated or implied. When a note is interest bearing, the principal amount (face value) recorded is the present value of the liability. The company records interest expense over the life of the note by applying the stated interest rate to the face value. When a note is non-interest-bearing, it is made out for the maturity value and discounted, and the borrower receives less than the face amount. The company systematically recognizes the difference between the face amount and the amount received (the interest element or discount) as interest expense over the life of the note. The company shows the discount currently remaining on its balance sheet as a contra account to Notes Payable in order to report the net amount of the current liquidation value.

13. The currently maturing portion of long-term debt includes any long-term debt whose retirement will require the use of current assets in the following year. This includes both term and serial bonds (which mature in installments). The current portion of other long-term debt, such as the current amount of lease obligations or certain deferred taxes, is treated in the same manner.

14. Dividends payable are current liabilities only when they have been declared by the board of directors and there is an intention to distribute the dividends within one year or operating cycle. However, companies do not report two types of dividends as current liabilities: (a) stock dividends to be issued (payable in the corporation’s own stock), which are reported as an element of stockholders’ equity, and (b) undeclared dividends in arrears on cumulative preferred stock, which are not reported as liabilities until they are formally declared by the board of directors (although they are disclosed in the notes to the financial statements).

15. Advances and refundable deposits are required by many companies (for example, utilities) to guarantee payment for equipment or future services provided to customers. Because these payments are either refundable or later offset against trade accounts receivable, they are liabilities.
16. **Accrued liabilities**, most of which are current liabilities, represent obligations that accumulate systematically over time. Often, for convenience, companies record these liabilities and their associated expenses at the end of the period. Accounting for several specific types of accrued liabilities is discussed in the chapter:

(a) Employees’ *compensated absences* include vacation, holiday, illness, or other personal activities for which employees are paid. A company recognizes an expense and accrues a liability for such absences if all of the following conditions are met: (1) the company’s obligation to compensate for future absences is related to past services by the employee; (2) the obligation relates to rights that vest or accumulate; (3) payment of compensation is probable; and (4) the amount can be reasonably estimated. A *vested right* exists when an employer has an obligation to make payment to an employee. *Accumulated rights* can be carried forward by the employee to future periods if they are not used in the period when earned.

(b) Disclosures in the notes to the financial statements are required regarding certain *unconditional purchase obligations* (a type of “off-balance-sheet financing”), regardless of whether the obligations and related assets are reported on the balance sheet. Such obligations require future transfers of funds for fixed or minimum amounts or quantities of goods or services at fixed or minimum prices.

(c) A company is required to *disclose* the fair value of all its financial instruments, either in the body of the financial statements or in the notes. Additionally, a company must *recognize* as liabilities any “derivative” financial instruments that are obligations and to *disclose* information about all its derivative instruments.

(d) In a *product financing arrangement* (a type of “off-balance-sheet financing”), a company “sells” inventory and agrees to repurchase it at a specified price. The company keeps the inventory on its balance sheet and does not record such a transaction as a sale. However, it records a liability for the proceeds received. When a company has another entity purchase products on its behalf, the company records the asset and related liability.

17. **Unearned items** (sometimes called deferred revenues) are amounts that a company has collected in advance but has not earned or recorded as revenues. Unearned items should be properly classified as current or long-term liabilities. Examples include advance collections of interest, rent, subscriptions, or tickets. Such items are current unless more than one year (or one operating cycle, if longer) is required in the earning process, or if noncurrent assets primarily are used to earn the revenue.

**Current Liabilities Whose Amounts Depend on Operations**

18. A **sales tax** is levied on the transfer of tangible personal property and on certain services. A seller collects sales tax from the customer and remits it to the proper governmental authority, usually monthly. Typically, the amount collected is recorded as a current liability until paid. Some businesses, however, include sales taxes in the price of merchandise and credit the Sales account for the sum of the sales amount and sales taxes payable. In this case, the company must make an adjusting entry when the remittance is due, to reduce the Sales account and create a current liability for sales taxes payable.

19. A **use tax** is levied by a state or local government on the buyer of merchandise purchased for the buyer’s own use or consumption, when goods are bought in a nonsales-tax area. A use tax is a liability of the buyer, who must file a use tax return and remit the tax.
20. **Payroll taxes** are paid by both the company (employer) and employee. Taxes withheld from employees’ pay include federal and state (and sometimes local) income taxes payable by the employee, and the employee’s social security (Federal Insurance Contribution Act or F.I.C.A.) taxes. Such withholdings are current liabilities of the employer until remitted. In addition, the employer must also pay taxes based on payroll, including employer’s social security and unemployment insurance taxes. Employer payroll taxes are an expense and a liability. Voluntary payroll deductions may also be made, through contractual agreement between individual employees and their employer. Examples include deductions for insurance, union dues, and retirement annuities.

22. Companies are subject to federal, state, and sometimes foreign income taxes. Companies report the various payables resulting from payroll as current liabilities. The journal entry to accrue income taxes payable is a debit to Income Tax Expense and a credit to Income Taxes Payable, a current liability. If prepayment of taxes is required, the company debits Prepaid Income Taxes and makes an adjustment to the expense, liability, and prepaid accounts when the actual liability for taxes is determined.

23. Many companies chose to pay bonuses as an incentive to certain employees. Bonuses are typically calculated by either basing the amount on the corporation’s income after deducting income taxes, but before deducting the bonus or on the income after deducting both the bonus and the income taxes.

### Current Liabilities Requiring Amounts to Be Estimated

24. **Property taxes** are assessed by local (and some state) governments on the value of property as of a given date. They become a legal liability on the date, specified by law, when a lien arises against the property. The Committee on Accounting Procedure recommended equal monthly accrual of property taxes. A company calculates the estimated property tax accrued by applying the estimated rate to the assessed valuation.

25. **Product warranties** require the seller, for a specified period of time after the sale, to correct deficiencies in the quality, quantity, or performance of merchandise, or replace items, or refund the selling price. Theoretically, the matching principle requires that companies estimate and record warranty expense and warranty obligation in the period of the sale. However, in practice other methods are also used to account for warranty costs:

   (1) The **expense warranty accrual method** is the theoretically correct method. A company using this method recognizes estimated warranty expense and warranty liability in the period of sale, with the warranty liability divided into current and long-term portions.

   (2) Many companies sell "service contracts," which require customers to make fixed payments for future services. Even when there is no separate service contract, the sales price may have two components—the price of the product and the price of an implied warranty. The **sales warranty accrual method** separates accounting for these two components **even when no separate service contract is involved**.

   (3) Under the **modified cash basis**, a company records warranty costs as an expense during the period when warranty expenditures are made. This method is required for income tax reporting. It is also often used for financial reporting, although it is conceptually unsound because it violates the matching principle.

26. Many companies offer **premiums** such as toys for product purchases, or cash **coupons** reducing or refunding purchase prices. A company matches the costs of such sales incentives as expenses against revenues in the period of the sale. At the end of the period, estimates of outstanding offers that will be redeemed within the next year (or operating cycle, if longer) are reported as current liabilities.
27. **Direct-response advertising** is advertising that is expected to produce sales resulting from customers’ specific responses to the advertising. The specific responses must be documented, for example, by coded coupons or coded order forms. A company capitalizes the following costs of direct-response advertising and amortizes them as advertising expense over the period of expected benefits, if the company provides evidence (e.g., historical patterns) that they will result in future net revenues: (a) incremental direct costs of transactions with independent third parties; and (b) payroll costs for employee activities directly related to the advertising. Costs of administration and occupancy are not capitalized.

### Contingencies

28. According to GAAP, a **contingency** is an existing condition, situation, or set of circumstances involving uncertainty that will ultimately be resolved when one or more events occur or fail to occur. This definition has three primary characteristics: (a) an existing condition, (b) uncertainty as to the ultimate effect of this condition, and (c) the resolution of the uncertainty based on one or more future events.

29. The FASB used three terms describing the likelihood that a loss contingency will be confirmed: (a) **probable** - the future event (or events) is likely to occur, (b) **reasonably possible** - the chance of the future event occurring is more than remote but less than likely, (c) **remote** - the chance of the future event occurring is slight.

30. A company **accrues** an estimated loss from a loss contingency in its accounts and reports the loss in its financial statements as a reduction of income and as a liability (or reduction of an asset) if (a) it is probable that a loss has occurred, and that a future event or events will confirm the loss, and (b) the amount of the loss can be reasonably estimated. It is not necessary to know the exact payee or the exact date of payment. If the two conditions have not been met, but it is reasonably possible that a loss may have been incurred, the company must disclose that loss contingency in a note to its financial statements. Disclosure must indicate the nature of the contingency and give an estimate of the possible loss or range of loss, or state that such an estimate cannot be made. Certain contingencies where the possibility of loss is only remote are also disclosed in the notes to the financial statements.

31. Loss contingencies that companies usually accrue include uncollectible receivables, and obligations related to property taxes, product warranties, and premium offers. Loss contingencies that may be accrued if they meet the two conditions include the threat of expropriation of assets, pending or threatened litigation, actual or possible claims and assessments, guarantees of indebtedness of others, and agreements to repurchase receivables. Loss contingencies that are **usually not** accrued include uninsured risk of loss or damage from fire or other hazards, general or unspecified business risks, and risk of loss from catastrophes assumed by property and casualty insurance companies. Pending lawsuits should be analyzed to decide on accrual or note disclosure.

32. Certain loss contingencies are disclosed as the possibility of loss is only remote. These include: direct and indirect guarantees of indebtedness of others, obligations of commercial banks under “standby letters of credit,” and guarantees to repurchase receivables that have been sold or otherwise assigned. An indirect guarantee is an agreement requiring one company to transfer funds to another entity if specified events occur whereby (a) the funds are legally available to creditors of the other entity, and (b) those creditors may enforce that entity’s claims against the company under the agreement.

33. Following the convention of conservatism, and the revenue recognition criteria, **gain contingencies** usually are not accrued. Instead, they are disclosed in the notes to the company’s financial statements.
Other Liability Classification Issues

34. The classification of debt as short term affects liquidity ratios such as current and acid-test ratios. The FASB issued guidelines on reporting short-term debt expected to be refinanced. Short-term obligations are excluded from a company’s current liabilities if (a) the company intends to refinance on a long-term basis, and (b) the company has the ability to refinance. The ability to refinance must be demonstrated by either (a) the issue of long-term obligations or equity securities after the balance-sheet date but before issuance of the statements, or (b) a bona fide long-term financing agreement is entered into before the balance sheet is issued.

35. GAAP requires that a company classify the entire amount of a long-term obligation as a current liability if a violation of a provision of the debt agreement makes (or will make if the violation is not corrected) the liability callable within one year from the balance sheet date or within one operating cycle. This requirement does not conform to the definition of current liabilities. It classifies obligations as current when they are legally callable, even though liquidation may not be expected during the current period.

Financial Statement Presentation of Current Liabilities

36. The FASB has provided broad rather than specific guidelines for the presentation of assets and liabilities on the balance sheet. Reporting of assets and liabilities should highlight the company’s liquidity and financial flexibility, and assets and liabilities measured by different attributes (e.g., historical cost, current cost, etc.) should be reported in separate categories. Most companies present current liabilities as the first classification under “Liabilities.” Companies usually list current liabilities in order of the average length of maturities, or according to amount (largest to smallest), or in order of liquidation preference (the order of legal claims against assets).

37. A company includes a description of all significant accounting policies as an integral part of its financial statements. Any major issue of significance affecting the measurement or disclosure of current liabilities is included in the notes to the financial statements. Other notes and other supplemental information regarding current liabilities are included when necessary for full disclosure.

SELF-EVALUATION EXERCISES

True-False Questions

Determine whether each of the following statements is true or false.

1. Accounts payable, notes payable, and sales tax payable are examples of nonlegal liabilities.

Answer: False

Nonlegal liabilities are those liabilities where there is no legal requirement that assets be transferred, but a transfer of assets typically occurs during the normal course of business. However, a company is under a contractual obligation to transfer assets for accounts payable, notes payable, and sales tax payable are examples of legal liabilities.
2. A liability may not be recorded until the identity of the recipient is known. **Answer: False**

The identity of the recipient of a liability is not a requirement for the recognition of a liability.

3. The term “financial flexibility” describes the nearness to cash of a company’s assets and liabilities. **Answer: False**

Financial flexibility refers to a company’s ability to use its financial resources to adapt to change. Liquidity describes the nearness to cash of a company’s assets and liabilities.

4. Stock dividends declared but not yet issued are not reported as current liabilities. **Answer: True**

Usually dividends that are declared but not yet paid are classified as a liability. However, a stock dividend will be paid from a company’s own stock and should be reported as an element of stockholders’ equity, not current liabilities.

5. A company must recognize dividends in arrears on cumulative preferred stock as liabilities, regardless of whether they have been formally declared. **Answer: False**

If a company has not declared dividends in arrears on cumulative preferred stock, the only requirement is that these dividends in arrears be disclosed in the notes to the financial statements.

6. The modified cash basis of accounting for warranty costs is a conceptually sound accounting method. **Answer: False**

The modified cash basis of accounting for warranty costs records the warranty costs as an expense in the period in which it makes repairs or provides warranty service. A more conceptually sound method is to match the expenses associated to warranties with the period in which the associated items that are warranted are sold.

7. A company may exclude short-term obligations from current liabilities if it can demonstrate the intent and the ability to refinance on a long-term basis. **Answer: True**

A company may exclude short-term obligations from current liabilities if it can meet two requirements: (1) they must demonstrate the intent to refinance the short-term obligations, AND (2) an ability to refinance the obligations on a long-term basis. The ability to refinance these obligations means that the company has either (1) issued the long-term obligation after the balance sheet date but before the issuance of the financial statements; or (2) that company has entered into a bona-fide long-term financing agreement before the financial statements are issued.

8. The interest element in an interest-bearing note payable is recognized by the borrower at the inception of the note. **Answer: False**

The face value of the note is recorded at the inception of the note. As time passes and interest is accrued, the interest is recognized as either an expense when paid or as an accrued expense until actually paid.
9. Liabilities are recorded for obligations where payments are expected as part of a company's normal operations, even if payments are not legally required.

Answer: True
When payments are expected through normal operations, even if they are not legally required, they are considered liabilities. An example of this type of liability is bonuses that companies pay to employees.

10. A use tax, levied by a state or local government when goods are sold in a nonsales-tax area, is a liability of the buyer.

Answer: True
A use tax is a tax levied by a state or local governmental unit on goods bought from a nonsales-tax area and used or consumed by the buyer in the state or local governmental units' area. These taxes are the responsibility of the user of the items.

11. Accrued liabilities and unearned revenues are examples of “off-balance sheet financing.”

Answer: False
“Off-balance sheet financing” can be used to address many topics. With respect to liabilities, the term is used when discussing unconditional purchase obligations or when a company “sells” inventory that it agrees to repurchase. These topics are discussed further in other chapters. Accrued liabilities and unearned revenue in many instances are current liabilities but they are not referred to as “off-balance sheet financing.”

12. All payroll taxes are an expense of the employer.

Answer: False
Companies are required by law to withhold portions of an employee's pay for anticipated federal and state taxes payable by the employee. While this amount is withheld by the company and is properly listed as a current liability until forwarded to the appropriate tax authorities, for the most part the taxes are an expense of the employee, not the employer. Exceptions to this are taxes withheld under the Federal Insurance Contribution Act (FICA), which covers social security and Medicare. These payments are made by both the employer and the employee.

13. According to generally accepted accounting principles, property taxes should be estimated and accrued monthly.

Answer: True
Property taxes are assessed by local and some state governments. These taxes are used by governments to provide essential services such as fire and police protection. Although these taxes are assessed and billed annually, a company should accrue an equal estimated amount each month. This method is preferred because it matches the property tax expense in the same period in which it receives services from the governmental units that are taxing the property.
14. A company capitalizes the costs of advertising.  

Answer: False  
Generally speaking, advertising is expensed as costs are incurred or the first time the advertising takes place. This method is used because it is difficult to measure future economic benefits resulting from the advertisements. An exception to this rule is for direct-response advertising. This is advertising that is expected to result in a customer’s decision to buy a product based on a specific response to the advertising.

15. A company must disclose unconditional purchase obligations only when it reports the obligations and related assets on the balance sheet.  

Answer: False  
If a company has an unconditional (noncancelable) obligation to purchase an asset at a specified price and the market price goes below the contract price, the company is required to accrue a loss and record a liability.

16. Obligations related to product warranties and premium offers are examples of loss contingencies, which are usually accrued.  

Answer: True  
Premium and product warranty obligations are usually accrued because the company can reasonably estimate the amount of liability arising from these transactions.

17. Gain contingencies are not accrued.  

Answer: True  
In keeping with conservatism, gain contingencies are not accrued. They are only recognized when actually realized. However, these gain contingencies may be disclosed in the notes to the financial statements.

18. Conceptually, a company should record all liabilities at the present value of the future outlays that will be required.  

Answer: True  
From a conceptual standpoint, all liabilities should be recorded at the present value of the amount required to satisfy these obligations. However, in reality, most current liabilities are recorded at their maturity value. The difference between these two values (present value vs. maturity value) is usually too small to be material in amount.

19. When an employer is obligated to make a payment to an employee, the employee’s right to that payment is “vested.”  

Answer: True  
A “vested” obligation exists when an employee has a right to payment and that payment is not contingent on future services.
Multiple Choice Questions

Select the one best answer for each of the following questions.

1. Which of the following is not an essential characteristic of a liability?
   (a) A liability embodies a present obligation to be settled by a probable future transfer or use of assets.
   (b) The obligated company has little or no discretion to avoid the future sacrifice.
   (c) The obligation is legally enforceable.
   (d) The transaction or event obligating the company has already happened.

   **Answer: (c)** The obligation is legally enforceable.

   Many liabilities are not legally enforceable, yet are still classified as liabilities. Examples of these obligations are vacation pay and employee bonuses, which a company is not legally required to pay. Answers (a), (b), and (d) are all essential characteristics of a liability and are therefore incorrect answers.

2. Which of the following dividends are not reported as current liabilities when declared?
   (a) cash dividends
   (b) stock dividends
   (c) property dividends
   (d) scrip dividends

   **Answer: (b)** stock dividends

   Most types of dividends are reported as current liabilities when declared. However, stock dividends are not a sacrifice of future economic benefits; they are merely an element of stockholders' equity. Note: dividends in arrears are a liability when declared; the fact pattern refers to “declared” dividends. So, the only type of declared dividends not considered current liabilities are stock dividends. ALL undeclared dividends are omitted from current liabilities.

   Cash dividends (answer (a)), property dividends (answer (b)), and scrip dividends (answer (d)) are all considered current liabilities because they represent the future sacrifice of economic benefits by the company.

3. Which of the following is an example of a nonlegal liability?
   (a) employee bonuses
   (b) accounts payable
   (c) notes payable
   (d) sales tax payable

   **Answer: (a)** employee bonuses

   Employee bonuses are usually a nonlegal liability because they do not represent a contractual obligation to pay.

   Answers (b), (c), and (d) are all contractual obligations required to be paid by the company. Each of these items is enforceable in a court and as such are legal liabilities.

4. Which of the following is not considered inventory?
   (a) Material used to make products for resale
   (b) Finished goods awaiting shipment to customers
   (c) Equipment used to manufacture products for resale
   (d) All of these items are considered inventory.

   **Answer: (c)** Equipment used to manufacture products for resale

   Equipment that is used to manufacture products for resale is not intended to be sold to customers, therefore it is not inventory. This equipment would most likely be considered a long-term asset. Answer (a) is incorrect because materials that are used to make products for resale are called raw materials and are a component of inventory. Answer (b) is incorrect because finished goods are a component of inventory. Answer (d) is incorrect because choice (c) is not considered to be inventory.
5. Which of the following loss contingencies is not usually accrued?
   (a) general business risks
   (b) noncollectibility of receivables
   (c) product warranty obligations
   (d) premium offer obligations
   (e) All of the above.

   **Answer: (a) general business risks**

   General business risks are not usually accrued as loss contingencies because of the inability of most businesses to adequately estimate the costs associated with general business risks and their inability to assess the certainty of these risks becoming realities.

   Answer (b) is incorrect because the noncollectibility of receivables can and usually is easily determined by most businesses based on past experiences. Remember that this was discussed at length in the chapter on cash and receivables. Answers (c) and (d) are also incorrect for the same reason as answer (b). These items are estimated based on past experiences with similar products or premiums. Answer (e) is incorrect because there is a correct answer: answer (a).

6. Short-term debt expected to be refinanced may be classified as long-term:
   (a) if there is an intent to refinance on a long-term basis.
   (b) only if long-term obligations are issued before the balance sheet date.
   (c) if off-balance-sheet financing has been obtained.
   (d) if there is an intent and the ability to refinance on a long-term basis.

   **Answer: (d) if there is an intent and the ability to refinance on a long-term basis.**

   FASB Statement No. 6 states that short-term obligations are excluded from a company's current liabilities if two conditions are met: (1) it intends to refinance the obligation on a long-term basis, and (2) it has the ability to refinance the debt on a long-term basis. Both the intent and ability must be present to exclude this debt from the current liabilities section.

   Answers (a) and (c) are incorrect because each of these answers contains only one of the two required components to exclude the short-term obligations from current liabilities. Each of the requirements must be met, not just one or the other. Answer (b) is incorrect. If the short-term debt had been replaced by long-term debt before the balance sheet date, the items would be properly accounted for as long-term debt, not current liabilities. However, issuance of the long-term obligations prior to the balance-sheet date is not the only way to reclassify the debt as long term as stated in answer (b).
7. The modified cash basis of accounting for warranty costs:
   (a) is seldom used for financial reporting.
   (b) is based on the matching concept.
   (c) is conceptually unsound.
   (d) requires warranty expense and warranty obligation to be estimated and recorded in the period of the sale.

   **Answer:** (c) is conceptually unsound.

   Under the modified cash concept of accounting for warranty costs, the expenses are only recognized in the period in which warranty repairs are made. This violates the matching principle because the company does not recognize expenses in the period in which the revenue was recognized.

   Answer (a) is incorrect because many companies use the modified cash method as long as the differences between this method and the warranty expense accrual method are not material in amount. Answer (b) is incorrect because the modified cash concept of accounting for warranty costs is not based on the matching principle. In fact, this method violates the matching principle. Answer (d) is incorrect because the modified cash concept of accounting for warranty costs does not use estimates or accruals.

8. Trade accounts payable:
   (a) should, theoretically, be recorded net of any cash discount.
   (b) are examples of liabilities that must be estimated and accrued.
   (c) do not include purchases on an open-charge basis.
   (d) are normally long-term liabilities.

   **Answer:** (a) should, theoretically, be recorded net of any cash discount.

   The net method of recording accounts payable usually more accurately reflects the actual amount the company will pay to satisfy their obligations. This method is generally preferred if the company normally takes sales discounts that are offered.

   Answer (b) is incorrect because trade accounts payable are usually known amounts and do not require estimation. Answer (c) is incorrect because a trade account payable is usually the result of purchases on an open-charge basis. Answer (d) is incorrect because trade account payables are rarely long-term liabilities.

9. Liquidity:
   (a) refers to an entity's ability to use its financial resources to adapt to change.
   (b) describes the nearness to cash of a company's assets and liabilities.
   (c) involves the potential to create new current and long-term debt.
   (d) involves the potential to restructure existing debt.

   **Answer:** (b) describes the nearness to cash of a company's assets and liabilities.

   Liquidity refers to how quickly a company can convert its assets to cash to pay its liabilities. In other words, how near a company's assets and liabilities are to cash.

   Answer (a) is incorrect because an entity's ability to use its financial resources to adapt to change is the entity's financial flexibility. Answers (c) and (d) are also incorrect because they too provide an indication of the company's financial flexibility and not its liquidity.
10. Which of the following conditions defines a contingency?
   (a) A contingency is an existing condition, situation, or set of circumstances.
   (b) A contingency involves uncertainty.
   (c) The uncertainty related to a contingency will be resolved by one or more future events.
   (d) All of the above.

   Answer: (d) All of the above.

   Answers (a), (b), and (c) are each a component of what defines a contingency. Each of these elements must be present.

11. The Rarey Company has reasonably estimated the following probable costs for the compensated absences of its employees:

   Vacation pay (vested) $5,000
   Vacation pay (accumulated but not vested) $3,000
   Sick pay (vested) $4,000
   Sick pay (accumulated but not vested) $2,000

   The costs are attributable to services that have already been rendered. In accordance with GAAP, the minimum amount that Rarey must accrue as its liability for compensated absences is:
   (a) $5,000.
   (b) $8,000.
   (c) $9,000.
   (d) $12,000.
   (e) $14,000.

   Answer: (d) $12,000.

   The amount that must be accrued by Rarey is $12,000 (vested vacation pay of $5,000; accumulated but not vested vacation pay of $3,000; and vested sick pay of $4,000). Under GAAP, sick pay and vacation pay are treated slightly differently. Vacation pay is required to be accrued as a liability if it is vested or accumulated but not vested. Sick pay on the other hand is only required to be accrued if it is vested. If sick pay is accumulated but not vested, accrual is allowed but not required.

   Answer (a) is incorrect because it only includes the vested vacation pay and excludes the accumulated vacation pay and vested sick pay. Answer (b) is incorrect because it includes both vested and accumulated vacation pay, which is correct, but excludes the vested sick pay. Answer (c) is incorrect because it only includes the vested vacation and sick pay (which is correct), but excludes the accumulated vacation pay. Answer (e) is incorrect because Rarey is not required to include the accumulated but not vested sick pay. Rarey may choose to accrue all of these items, but is not required to include the accumulated sick pay.

Problem-Solving Strategies

Notes Payable

A note payable is an unconditional written agreement to pay a sum of money to a bearer on a specific date. These notes can be either short term or long term based on the same definition used for other liabilities. These notes usually come in two varieties: interest bearing or non-interest bearing. An interest-bearing note will list the principal as the face value and an annual interest rate as well as the date when the principal and interest are due. A non-interest-bearing note will generally only include the maturity value and the date. The maturity value includes both the principal and interest at maturity. The interest is determined by the amount that the note is discounted. In other words, we will receive cash or assets worth less than the face value of the note. The difference between the face value of the note and the value of what we receive is the interest expense. Let’s do a couple examples of these types of notes.
**Strategy:** Remember that interest rates are always expressed in annual terms. When the note is less than a year, you must adjust the rate accordingly to correctly determine the interest expense.

**Interest Bearing**

On January 1, 2011, we purchase inventory by issuing a $5,000, 6%, 90-day note payable.

January 1, 2011, entries:

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory</td>
<td>5,000</td>
<td></td>
</tr>
<tr>
<td>Notes Payable</td>
<td></td>
<td>5,000</td>
</tr>
</tbody>
</table>

When the note is paid on April 1, 2011, the entry would be:

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest Expense ($10,000 × 0.06 × 90/360)</td>
<td>75</td>
<td></td>
</tr>
<tr>
<td>Notes Payable</td>
<td></td>
<td>5,000</td>
</tr>
<tr>
<td>Cash</td>
<td>5,075</td>
<td></td>
</tr>
</tbody>
</table>

**Non-Interest Bearing**

On January 1, 2011, we borrow money by issuing a $20,000, 6-month, non-interest-bearing note that is discounted at a 10% rate. We will receive $19,000 in cash on January 1, 2011 ($20,000 × 0.10 × 6/12). We will be required to pay back $20,000 on July 1, 2011.

January 1, 2011, entries:

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>19,000</td>
<td></td>
</tr>
<tr>
<td>Discount on Notes Payable</td>
<td>1,000</td>
<td></td>
</tr>
<tr>
<td>Notes Payable</td>
<td></td>
<td>20,000</td>
</tr>
</tbody>
</table>

When the note is paid on July 1, 2011, the entry would be:

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest Expense</td>
<td>1,000</td>
<td></td>
</tr>
<tr>
<td>Notes Payable</td>
<td>20,000</td>
<td></td>
</tr>
<tr>
<td>Discount on Notes Payable</td>
<td></td>
<td>1,000</td>
</tr>
<tr>
<td>Cash</td>
<td></td>
<td>20,000</td>
</tr>
</tbody>
</table>

**Payroll Taxes**

Companies are required by law to withhold a certain amount from the pay of each employee for anticipated federal and state taxes payable by employees. In addition, employees may voluntarily withhold amounts for other nontax items such as health insurance, retirement savings, etc. In addition to the items that the employer withholds from the employee's pay, the employer is also responsible for tax payments based on the employee's wages. These employer-responsible payments include social security taxes and unemployment taxes.

A typical payroll journal entry using an assumed F.I.C.A. rate of 16% (8% on the employer and 8% on the employee) for the employee is:
Salary Expense 10,000
  F.I.C.A. Taxes Payable (8% x $10,000) 800
  Employee Federal Income Tax Withholding 730
  Employee State Income Tax Withholding 300
  Employee Insurance premium 100
  Cash 8,070

A typical payroll journal entry using an assumed F.I.C.A. rate of 16% (8% on the employer and 8% on the employee) for the employer is:

Payroll Tax Expense 1,150
  F.I.C.A. Taxes Payable (8% x $10,000) 800
  Federal Unemployment Taxes Payable 80
  State Unemployment Taxes Payable 270

Strategy: The employee pays the insurance premiums and their own taxes. The employer pays unemployment taxes. Both the employee and the employer pay F.I.C.A. taxes.

Product Warranties

A product warranty requires that the seller repair or replace any defective item during an initial period of time. Because most warranties cover more than the period in which the sale is made, in order to match expenses to revenue we must estimate warranty costs for future periods. There are three methods of accounting for warranty costs: 1) expense warranty accrual method; 2) sales warranty accrual method; and 3) modified cash basis method.

Expense Warranty Accrual Method

In the expense warranty accrual method, a company estimates and recognizes the warranty expenses for all the sales during the period by creating a liability account. As warranty costs are incurred, this liability account is reduced.

Assume that in 2011 a product sells for $150 per unit. The product is sold with a one-year warranty and is estimated to have warranty expenses of 5% per unit. In 2011, we sold 20,000 units, and had $80,000 worth of warranty expense. In 2012, we had warranty expenses of $75,000. The journal entries for these transactions would be:

Sales transactions (2011):
  Cash or Accounts Receivable (20,000 x $150) 3,000,000
  Sales 3,000,000

Recognition of Warranty Expenses (2011):
  Warranty Expense (5% x $3,000,000) 150,000
  Estimated Liability under Warranty 150,000

Warranty costs for 2011:
  Estimated Liability under Warranty 80,000
  Cash (or other assets) 80,000

Warranty costs for 2012:
  Estimated Liability under Warranty 70,000
  Warranty Expense 5,000
  Cash (or other assets) 75,000
Strategy: The extra $5,000 of warranty expense in the 2012 entry came from underestimating the expected warranty costs. This $5,000 will be reported in 2012 because it is a change in accounting estimates.

Sales Warranty Accrual Method

Under the sales warranty accrual method, companies account for the warranty as a separate component of the product. In most instances, this is because the warranty is sold separately from the product. These types of warranties are usually called service contracts or extended warranties and are common when the cost of the product is large. Examples might include automobiles or household appliances. This method is also used when a company segregates the cost of its product from the cost of the warranty. In this method, the company defers the recognition of the revenue from the warranty until the actual warranty costs are incurred.

Assume that in 2011 a product sells for $1,500 per unit. This price represents $1,400 for the item and $100 for the warranty associated with the product. In 2011, we sold 250 units, and had $15,000 worth of warranty expense. In 2012, we had warranty expenses of $12,500. The journal entries for these transactions would be:

Sales transactions (2011):
- Cash or Accounts Receivable (250 × $1500) 375,000
- Sales (250 × $1,400) 350,000
- Unearned Warranty Revenue (250 × $100) 25,000

Warranty costs for 2011:
- Warranty Expense 15,000
- Cash (or other assets) 15,000

Warranty revenue recognition for 2011:
- Unearned Warranty Revenue 15,000
- Warranty Revenue 15,000

Warranty costs for 2012:
- Warranty Expense 12,500
- Cash (or other assets) 12,500

Warranty revenue recognition for 2012:
- Unearned Warranty Revenue 10,000
- Warranty Revenue 10,000

Strategy: Note that under this method the company only recognizes the revenue that equals the estimated warranty costs. The excess costs above the estimate are warranty expenses that are recognized in 2012.
1. The Bitternut Company began operations on January 1, 2011. The company estimates that $0.06 of warranty costs will be incurred for each $1 of sales. In 2011, Bitternut's sales were $100,000, and payments arising out of warranty obligations were $4,000.

(a) Prepare the December 31 journal entry for warranty expense using the modified cash basis.

(b) Prepare the December 31 journal entries for warranty expense using the expense warranty accrual method.

(c) Prepare journal entries for the sales and warranties using the sales warranty accrual method.
2. On July 1, 2011, Bitternut issued a four-year note at a face amount of $40,000. Proceeds of the note were $36,000. No interest was stated.

(a) Prepare journal entries to record the issuance of the note on July 1, and interest expense (using the straight-line method) at December 31, 2011.

(b) Show the balance-sheet presentation of the note at December 31, 2011.
3. The Tiller Company deducted the following amounts from employees’ paychecks in August 2011.

\[
\begin{aligned}
\text{F.I.C.A.} & \quad 2,295 \\
\text{Federal income tax} & \quad 2,121 \\
\text{State income tax} & \quad 900 \\
\text{Union dues} & \quad 100 \\
\text{Insurance premiums} & \quad 300
\end{aligned}
\]

Tiller pays state unemployment taxes of 5.4% and federal unemployment taxes of 0.8%. Employee paychecks totaled $24,284 in August. Record the payroll journal entries for August.
Answers to Test Your Knowledge

1. (a) Warranty Expense 4,000
   Cash 4,000
   To record payment of warranty costs.

   (b) Warranty Expense 6,000
       Estimated Liability Under Warranties 6,000
       To record warranty expense associated
       with sales for the period.

       Estimated Liability Under Warranties 4,000
       Cash 4,000
       To record payment of warranty costs.

   (c) Cash (or Accounts Receivable) 100,000
       Sales 94,000
       Unearned Warranty Revenue 6,000
       To record sales of products and warranties.

       Warranty Expense 4,000
       Cash 4,000
       To record warranty expense incurred.

       Unearned Warranty Revenue 4,000
       Warranty Revenue 4,000
       To record warranty revenue in an amount
       equal to warranty costs incurred.

2. (a) Cash 36,000
       Discount on Note Payable 4,000
       Note Payable 40,000
       To record issuance on July 1 of a four-
       year note at a face amount of $20,000.

       Interest Expense \([\frac{\$4,000}{4 \text{ years}} \times \frac{1}{2}]\) 500
       Discount on Note Payable 500
       To record interest on note.

   (b) Note Payable $40,000
       Less Discount on Note Payable (3500)
       $36,500
3. Salaries Expense 30,000
   - F.I.C.A. Taxes Payable 2,295
   - Employee Federal Income Taxes Withholding Payable 2,121
   - Employee State Income Taxes Withholding Payable 900
   - Employee Insurance Premiums Withholding Payable 300
   - Employee Union Dues Withholding Payable 100
   - Cash 24,284
To record salaries expense.

Payroll Taxes Expense 4,155
   - F.I.C.A. Taxes Payable 2,295
   - Federal Unemployment Taxes Payable 240
   - State Unemployment Taxes Payable 1,620
To record payroll taxes expense.