Accounting Fundamentals Lesson 8

## 8.0 Liabilities

Current liabilities - Obligations that are due within one year.

Obligations due beyond that period of time are classified as long-term liabilities.

Current liabilities are those with:

- Known amounts
- Estimated amounts

Current liabilities of a known amount include:

- Accounts payable
- Short-term notes payable
- Sales tax payable
- Accrued liabilities (accrued expenses)
- Payroll liabilities
- Unearned revenues
- Current portion of long-term debt

Amounts owed for products or services purchased on account are accounts payable.

An important measure of liquidity for a retail business is accounts payable turnover.

Accounts payable turnover measures the number of times a year that a company is able to pay its accounts payable.

The calculation is:

$$\text{Accounts Payable Turnover (T/O)} = \frac{\text{Cost of Goods Sold}}{\text{Average Accounts Payable}}$$

Companies with shorter payment periods are generally better credit risks than those with longer payment periods.

However, some companies with strong credit ratings strategically withhold payment to suppliers as long as possible, while speeding up collections, in order to conserve cash.

Short-term notes payable - common form of financing, notes are due within one year.

Companies may issue short-term notes payable to borrow cash or to purchase assets. A company must accrue interest expense and interest payable at the end of the period.

Sales Tax Payable - Most states levy a sales tax on retail sales. Retailers collect the tax from customers and thus owe the state for sales tax collected.

Payroll - also called employee compensation, is a major expense for most companies such as service organizations—such as law firms, real estate companies, and airlines.

Employee compensation takes many different forms.

Salary - employee pay stated at a monthly or yearly rate.

Wage - is employee pay stated at an hourly rate.

Commission - is a percentage of the sales the sales employee has made.

Bonus - is an amount over and above regular compensation.

A typical entry to record payroll:

| JOURNAL | | | |
|---|---|---|---|
| Date | Accounts and explanation | Debit | Credit |
| | Salary Expense | | |
| | Employee Income Taxes payable | | |
| | FICA Taxes Payable | | |
| | Salary Payable to Employees | | |
| | *To record sales expense.* | | |

Salary expense represents gross pay (that is, employee pay before subtractions for taxes and other deductions).

Salary expense creates several payroll liabilities:

- Employee Income Tax Payable - the employees' income tax that has been withheld from paychecks.

- FICA Tax Payable includes the employees' - Social Security tax and Medicare tax, which also are withheld from paychecks.

  (FICA stands for the Federal Insurance Contributions Act, which created the Social Security tax.)

- Salary Payable to employees is their net (take-home) pay.

The most common current liabilities of an unknown amount:

- Estimated warranty payable
- Contingent liabilities.

Warranty Payable:

Many companies guarantee their products under warranty agreements. The warranty period may extend for 90 days to a year for consumer products.

At the time of the sale, however, the company doesn't know which products are defective. The exact amount of warranty expense cannot be known with certainty, so the business must estimate warranty expense and the related liability.

| JOURNAL | | | |
|---|---|---|---|
| Date | Accounts and explanation | Debit | Credit |
| | Warranty Expense | | |
| | Estimated Warranty Payable | | |
| | *To accrue warranty expense.* | | |
| | Estimated Warranty Payable | | |
| | Inventory | | |
| | *To replace defective parts under warranty.* | | |

Contingent liabilities:

A contingent liability is not an actual liability. Instead, it's a potential liability.

Examples of future obligations for contingent liabilities:

- Lawsuits,
- Tax disputes
- Alleged violations of environmental protection laws

Guidelines to account for contingent liabilities:

1. Probable - Accrue (i.e., make an adjusting journal entry for) a contingent liability if it's probable that the loss (or expense) will occur and the amount can be reasonably estimated. An example is a lawsuit that has been settled as of the balance sheet date but has not yet been paid.

2. Possible - Disclose a contingency in a financial statement note if it's reasonably possible that a loss (or expense) will occur. Lawsuits in progress are a prime example.

3. Unlikely - There is no need to report a contingent loss that is unlikely to occur. Instead, wait until an actual transaction clears up the situation.

## 8.1 Bonds Payable

In order to raise large sums of money, corporations sometimes issue (sell) bonds to the public.

Bonds payable are groups of notes payable issued to multiple lenders (bondholders).

Bonds payable are debts of the issuing company.

The bond certificate held by the bondholder will state the interest rate that the issuer will pay the holder and the due dates for the interest payments.

Bonds may either be term bonds (mature at the same time) or serial bonds (mature in installments over a period of time).

Bonds may also be either secured or unsecured.

Secured bonds, or mortgage bonds - give the bondholder the right to take specified assets of the issuer if the company defaults—that is, fails to pay interest or principal.

Unsecured bonds, or debentures - bond backed only by the good faith of the borrower. Debentures carry a higher rate of interest than secured bonds because debentures are riskier investments.

Bonds may either be issued at face (par) value, a premium, or a discount.

Bonds issued at a price above its face value are issued at a premium (credit balance).

Bonds issued at a price below face value are issued at a discount (debit balance).

Bonds are always sold at their market price, which is the amount charged to investors to purchase the bond.

The market price is the bond's present value, which equates to the present value of the principal payment plus the present value of the cash interest payments.

| Issue Price of Bonds Payable | | | | |
|---|---|---|---|---|
| Case A | | | | |
| Stated interest rate | = | Market interest rate | Therefore, → | Issued at Par |
| Case B | | | | |
| Stated interest rate | < | Market interest rate | Therefore, → | Issued at Discount |
| Case C | | | | |
| Stated interest rate | > | Market interest rate | Therefore, → | Issued at Premium |

The stated interest rate is the rate printed on the bond certificate.

The market interest rate is the rate that investors demand for loaning their money. Many times, these two rates will differ.

Companies must analyze how to get the money they need to pay for assets. They may finance operations by retained earnings, by issuing stock, or by issuing bonds (or notes) payable.

Each option has advantages and disadvantages, and companies must analyze each to determine the best option.