Current Liabilities and Contingencies

CURRENT LIABILITIES

FASB Statement of Financial Accounting Concepts No. 6 defines 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.”

The key elements of this definition are:
• Liabilities are present obligations requiring probable future transfer of assets
• Liabilities are unavoidable obligations
• The transaction or event creating the liability has already occurred

Open Accounts and Notes Payable
• Accounts payable are amounts owed vendors and/or suppliers for goods, supplies and services acquired in the normal course of business.
• Trade notes payable are written obligations, in the form of a promissory note, to pay a sum certain at a future date typically with interest.
• Short-term notes payable
  ▪ Line of credit
    A line of credit is an arrangement with the bank whereby the company can borrow up to a certain specified amount for a short-term period of time (normally less than one year).
  ▪ Secured loans
    A short-term loan is normally secured by accounts receivable and/or inventory.
• Commercial paper
  ▪ Large companies with good credit may offer notes in for form of commercial paper.
    These are short-term unsecured notes that are traded among banks and private investors.
• Current maturities of long-term debt are the principal portion of long-term obligations that become due within the next year or operating cycle. The entire long-term amount is normally listed under long-term debt with a deduction for the current maturities. The current maturities are then listed as one amount in the current portion of the liabilities section of the balance sheet
• Short-term obligations expected to be refinanced is a special category of liability that requires special attention. If certain refinancing criteria are met and the refinanced obligation will be long-term, the liability may be classified as long-term rather than current. Both of the following conditions must be met for the obligation to be classified as long-term:
  1. Management must intend to refinance the obligation on a long-term basis, and
  2. Management must demonstrate an ability to consummate the refinancing.
    a) This can be accomplished by actually refinancing the obligation after the balance sheet date but before the issuance of the financial statements, or
    b) By entering into a financing agreement that is binding and the terms are readily determinable
• Dividends payable are cash dividends that have been declared by the board of directors. Dividends payable do not include dividends in arrears on preferred stock nor do they include stock dividends.
• Returnable deposits are cash deposits received from customers or employees that are to be returned at some future date.
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- **Unearned revenues** are deferred income. The entity has received the cash but has not earned it on the balance sheet date.

- **Sales taxes payable** represents the sales taxes collected on behalf of the state. The entity is acting as a fiduciary and has the obligation to forward the sales tax to the state on a timely basis.

- **Income taxes payable** are the income taxes due on corporate earnings. Normally a corporate entity pays estimated quarterly installments so that at the end of the year the remaining obligation reflects the last quarterly estimate plus any adjustment for the actual tax obligation based on the final income before income taxes. The quarterly estimated tax payments are normally debited to income tax payable during the year. Once the corporation has calculated the income before income taxes the final adjusting journal is prepared as follows:

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income tax expense</td>
<td>XXX</td>
<td></td>
</tr>
<tr>
<td>Income tax payable</td>
<td></td>
<td>XXX</td>
</tr>
<tr>
<td><strong>To record income tax expense for the year</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

  This final adjusting journal entry records the expense for the year based on income before income tax and adjusts the income taxes payable to the correct obligation at year-end.

- **Compensated absences**
  Compensated absences include sick leave, vacation, and holiday pay. For these obligations to be booked as current liabilities all of the following conditions must be met.
  1. The obligation is for services that have already been rendered
  2. The employee rights either vest or accumulate
     - **Vested rights:** the obligation is not contingent on the employee’s future employment with the entity.
     - **Accumulated rights:** if not used the rights can be carried forward to future periods.
  3. Payment is probable, and
  4. The amount of compensation can be estimated

- **Bonuses**
  Many entities have profit-sharing agreements with employees and officers. The obligation is typically calculated after the year-end income is determined. Such obligations are considered current liabilities.