UNIT – 11

**Accounting for Short-Term Liability**

In accounting, **current liabilities (short-term liabilities)** are often understood as all liabilities of the business that are to be settled in cash within the fiscal year or the operating cycle of a given firm, whichever period is longer.

A more complete **definition** is that current liabilities are obligations that will be settled by current assets or by the creation of new current liabilities. *Accounts payable are due within 30 days, and are paid within 30 days, but do often run past 30 days or 60 days in some situations*.

The laws regarding late payment and claims for unpaid accounts payable is related to the issue of accounts payable. **An operating cycle for a firm is the average time that is required to go from cash to cash in producing revenues.** For example, accounts payable for goods, services or supplies that were purchased for use in the operation of the business and payable within a normal period would be **current liabilities /short term liabilities**. Amounts listed on a balance sheet as accounts payable represent all bills payable to vendors of a company, whether or not the bills are less than 31 days old or more than 30 days old. Therefore late payments are not disclosed on the balance sheet for accounts payable. There may be footnotes in audited financial statements regarding age of accounts payable, but this is not common accounting practice. Lawsuits regarding accounts payable are required to be shown on audited financial statements, but this is not necessarily common accounting practice.

Bonds, mortgages and loans that are payable over a term exceeding one year would be fixed liabilities or long-term liabilities. **However, the payments due on the long-term loans in the current fiscal year could be considered current liabilities if the amounts were material.** Amounts due to lenders/ bankers are never shown as accounts payable/ trade accounts payable, but will show up on the balance sheet of a company under the major heading of current liabilities, and often under the sub-heading of other current liabilities, instead of accounts payable, which are due to vendors. Other current liabilities are due for payment according to the terms of the loan agreements, but when lender liabilities are shown as current vs. long term, they are due within the current fiscal year or earlier. Therefore late payments from a previous fiscal year will carry over into the same position on the balance sheet as current liabilities which are not late in payment. There may be footnotes in audited financial statements regarding past due payments to lenders, but this is not common practice. Lawsuits regarding loans payable are required to be shown on audited financial statements, but this is not necessarily common accounting practice.

The proper classification of liabilities provides useful information to investors and other users of the financial statements. It may be regarded as essential for allowing outsiders to consider a true picture of an organization's fiscal health.

**Ques**. Explain current/short- term liabilities.

**Ans.** In accounting, **current liabilities (short-term liabilities)** are often understood as all liabilities of the business that are to be settled in cash within the fiscal year or the operating cycle of a given firm, whichever period is longer.

A more complete **definition** is that current liabilities are obligations that will be settled by current assets or by the creation of new current liabilities.

## Current Liabilities for Companies

* **Accounts payable** - This is money owed to suppliers.
* **Accrued expenses** - These are monies due to a third party but not yet payable; for example, wages payable.
* **Accrued Interest** - This includes all interest that has accrued since last paid.
* **Bank account overdrafts** - These are short term advances made by the bank for overdrafts.
* **Bank loans or notes payable** -This is the current principal portion of a long-term note.
* **Current maturities of long-term debt** - This is the part of a long term debt that is due in the upcoming 12 months.
* **Customer deposits or unearned revenue** - These are payments given by customers as an advance for future work that is expected to be completed by the end of the next 12 months.
* **Dividends payable** - These are the dividends declared by the company Board of Directors that have not yet been paid to the shareholders.
* **Income taxes payable** - These are taxes owed to the government that have not yet been paid.
* **Interest payable** - This is interest owed to lenders that has not been paid.
* **Notes payable (other than bank notes)** - This is the current principal portion of long-term notes.
* **Payroll taxes payable** - This is taxes withheld from employees or taxes related to employee compensation.
* **Rental payments** - These are paid for renting buildings, land, pastures, or other property or structures.
* **Short-term notes payable** - These loans are due upon demand or within the next year.
* **Sales taxes payable** - These are taxes collected from customers for the government that need to be paid to the government.
* **Wages** - These are owed to employees.

**Ques.** Give some examples of company’s short- term liabilities.

Ans. Following are the some short – term liabilities of companies.

Accounts payable, Bank loans or notes payable, Sales taxes payable, Short-term notes payable, Dividends payable etc.

## Payroll Current Liabilities

* Accrued salaries and wages payable
* Employee Federal income tax withheld
* Employee state income tax withheld
* Employee local income tax withheld
* Employee FICA withheld(Federal/Central insurance Contribution Act)
* Employee Medicare withheld
* Employee garnishments withheld
* Employee benefits including employee insurance deduction withheld
* Employer provided benefits
* Employer FICA contribution payable
* Employer Medicare contribution payable
* Employer Federal unemployment payable
* Employer state unemployment payable
* Employer Workmen's Compensation insurance payable
* Employer provided health insurance payable
* Employer provided life insurance payable

**Ques**. Define payroll in a company.

**Ans**. In a [company](http://en.wikipedia.org/wiki/Company), **payroll** is the sum of all [financial](http://en.wikipedia.org/wiki/Financial) records of [salaries](http://en.wikipedia.org/wiki/Salary) for an employee, [wages](http://en.wikipedia.org/wiki/Wage), bonuses and [deductions](http://en.wikipedia.org/wiki/Tax_deduction).

In accounting, payroll refers to the amount paid to employees for services they provided during a certain period of time. Payroll plays a major role in a company for several reasons.

**Ques**. What is the mission of payroll department?

**Ans.** The primary mission of the payroll department is to ensure that all employees are paid accurately and timely with the correct withholdings and deductions, and to ensure the withholdings and deductions are remitted in a timely manner. This includes salary payments, tax withholdings, and deductions from a [paycheck](http://en.wikipedia.org/wiki/Paycheck).

## Accrued and Estimated Liabilities

* Accrued real estate and property taxes payable
* Accrued income and franchise taxes payable
* Accrued Federal taxes payable
* Accrued state taxes payable
* Accrued local taxes payable

## Personal Current Liabilities

* Car loans
* Credit card debt
* Current monthly bills - rent, utilities, insurance, etc
* Home equity loan
* Home mortgages
* Lines of credit
* Loans for investment purposes
* Miscellaneous debts - hospital charges for example
* Personal loans
* Rental or other property mortgage
* Student loans
* Unpaid Income Tax
* Unpaid Taxes and Interest

These different examples of current liabilities for companies and for individuals show the breadth of liability which could be the obligation of a company or individual.

**Ques.** What is line of credit?

**Ans.** A line of credit is an amount that a bank loans to a business.

A bank usually charges more for a credit line than for a fixed term

Loan.

**Ques.** Write down some short –term personal liabilities.

**Ans.** Following are the some short term personal liabilities.

Car loans

Credit card debt

Current monthly bills - rent, utilities, insurance, etc

Home equity loan

Home mortgages

Lines of credit

Loans for investment purposes

Miscellaneous debts - hospital charges for example

Personal loans

Rental or other property mortgage

Student loans

Unpaid Income Tax

Unpaid Taxes and Interest

Warranty liability

When a firm sells products or renders services with a warranty, the firms has an obligation towards the customer when the warranty is honored. The warranty liability is an estimate of the obligations. Hence, a product warranty for some product is based on expected breakdowns, the probability that the product is returned for repair, and estimates for material and labor needed to repair the product.

The matching principle requires that the expense of providing warranty needs to be allocated in the period of the sale, at the same time the gain of the sale is recognized. At the time of sale the firm expenses the expected cost of the warranty, which is added to the warranty liability. When at a future point in time the warranty is honored, no expenses need to be booked as for this purpose the warranty liability was created. Thus, at the time warranty is honored, the liability is reduced.

**Example**

The firm sells phones with a one year warranty. In the current month, the firm has sold 1,000 units. The expected percentage of phones that need to be replaced is 1%. The expected cost of replacement is SR 20.

The journal entry at the time of sale related to the warranty:

|  |  |  |  |
| --- | --- | --- | --- |
| Particulars | Debit | Credit |  |
| Warranty expense a/c | 200 |  |  |
| To Warranty liability a/c |  | 200 |  |

During the same month, 15 previously sold phones were required to be replaced under the warranty.

The journal entry for the replacements under the warranty:

|  |  |  |  |
| --- | --- | --- | --- |
| Particulars | Debit | Credit |  |
| Warranty liability a/c | 300 |  |  |
| To Inventory a/c |  | 300 |  |

It is possible that the warranty liability will appear to be too high (or too low) at some point in time. If the liability turns out to be too low, additional expenses need to be booked. (See Dell’s 4.1 million laptop battery recall program, for example.) If the liability is too high, some of the expenses can be reversed.

**Example**

At the end of the period, the firm has a warranty liability of 100,000. However, the expected cost of honoring warranty is expected to be 60,000. Thus, the liability is overstated by 40,000.

The journal entry to correct the warranty liability:

|  |  |  |  |
| --- | --- | --- | --- |
| Particulars | Debit | Credit |  |
| Warranty liability a/c | 40,000 |  |  |
| To Warranty expense a/c |  | 40,000 |  |

The use of the warranty liability is similar in nature as the allowance for uncollectible accounts. The warranty liability is about the risk in the products sold, whereas the allowance for uncollectible accounts is about the risk of non-payment by customers. The main difference between the two is that the warranty liability is a liability, whereas the allowance for uncollectible accounts is a correction on an asset.

**Key points:**  
- at the time of the sale, the expected cost of warranty is expensed by recognizing a warranty liability, which is in line with the matching principle  
- when the firm is using resources to honor the warranty, the warranty liability is reduced  
- when the warranty is either too high or too low, a correcting entry is made so that the warranty liability is in line with expected future warranty obligations

## Long term liabilities

## Long term liabilities are obligations that are due one year or longer after the end of the period. Since the time value of money can be large, long term liabilities are often valued at their present value, where current liabilities are at nominal value.

## There are two basic rules that are important when dealing with liabilities that are at present value. First, by the passing of time the liability grows, which is an interest expense. Second, liabilities are reduced when money is paid.

**Example**

At the beginning of the year, the firm has loan of SR 10,000. The interest rate is 5%. At the end of the year, SR 500 interest is paid.

The journal entry of the interest expense:

|  |  |  |  |
| --- | --- | --- | --- |
| Particulars | Debit | Credit |  |
| Interest expense a/c | 500 |  |  |
| To Cash a/c |  | 500 |  |

Then, the firm decides to sell a machine and use the proceeds of 4,000 to partially pay down the loan.

The journal entry of this payment:

|  |  |  |  |
| --- | --- | --- | --- |
| Particulars | Debit | Credit |  |
| Note payable a/c | 4,000 |  |  |
| To Cash a/c |  | 4,000 |  |

Key points:  
- long term liabilities are (normally) valued at present value  
- when a liability is interest-bearing, the passing in time will result in interest expenses   
- when money is paid (or products delivered/services rendered), the liability is reduced

Bonds

Issuing a bond is a way for a company to raise funds. When the bond is issued, the firm receives money from the investors which in turn become bondholders who will receive interest payments ([‘the coupon’](http://en.wikipedia.org/wiki/Coupon_(bond))), and at maturity, receive the repayment of the principal.

When the firm is issuing a bond, the firm is offering to pay the nominal interest and the nominal amount of the bond. Because of legal proceedings, there is some time lag between deciding on the terms of the bond (which is a binding contract), and the actual bond issue. As market interest rates are changing continuously, it is not possible for the firm to ‘match’ the nominal interest rate with the rate that the market requires. Instead, changes in the market interest rates result in an issue price for the bond that is potentially different than the face value.

When the market requires a higher rate of return than the firm offers, investors will still be interested in buying the bond. However, they will require a discount. Similarly, when the market interest rate is below the nominal interest rate, investors will bid up, and pay a premium. Investors will bid a price where they will make their required return, regardless the terms of the bond.

**Example**

The firm is issuing a 100 bonds, each with a 1,000 face value with a maturity of 5 years and nominal interest of 8%. At the day the bond issue is settled, investors are willing to pay 102% of the face value, i.e. 1,020 for each bond. The value of 1,020 corresponds with an effective interest rate of 7.5%.

Important: even though the interest payments are based on the nominal interest rate, the interest expense will equal the effective interest rate. When the investor earns the effective interest rate on its investment, the firm – as the party on the other side of the same deal – must have the same percentage as the effective interest expense.

In summary: when dealing with bonds, there are two percentages. The nominal interest rate which determines the interest payments and the effective interest rate, which is the interest expense. These are not the same because although the repayment at maturity is fixed by contract, the money received at time of issue determines the effective interest rate. Thus, a bond can be issued at the nominal value (at ‘par’), at a premium, or at a discount. The discount/premium is recorded on a contra T-account.

**Example (continued)**

The firm is issuing a 100 bonds, each with a 1,000 face value with a maturity of 5 years and nominal interest of 8%. At the day the bond issue is settled, investors are willing to pay 102% of the face value, i.e. 1,020 for each bond. The value of 1,020 corresponds with an effective interest rate of 7.5%.

At the day the issue is finalized, the market interest rate that is used to price this bond is 7.5%. Therefore, the bond is issued at a premium.

The value of a single bond is computed by discounting the cash flows (interest payment and repayment at maturity):

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Period | Amount | Discount factor | Present value |  |
| 1 | 80 | 1/1.075 | 74.42 |  |
| 2 | 80 | 1/1.075^2 | 69.23 |  |
| 3 | 80 | 1/1.075^3 | 64.40 |  |
| 4 | 80 | 1/1.075^4 | 59.90 |  |
| 5 | 1,080 | 1/1.075^5 | 752.28 |  |
|  | \_\_\_\_\_ |  | \_\_\_\_\_ |  |
|  | 1,400 |  | 1,020.23 |  |

Thus, for an investor that is using 7.5% as the interest rate, 74.42 today is equivalent to 80 one year later. Similarly, an investor (using 7.5%) is indifferent between buying the bond for 1,020.23 or not buying the bond.

The total interest expense equals the total interest payments minus a premium or plus a discount. In other words, when a bond is issued at a premium, the premium is a gain for the company, because it will only need to repay the nominal value. Similarly, when it is issued at a discount, the discount is an additional expense on top of the interest payments, because the firm will need to repay the nominal value (as this is determined by the bond contract). The matching principle requires that the discount/premium needs to be allocated over the lifetime of the bond.

There are two methods to allocate the premium/discount to the duration of the bond: the straight line method, and the effective interest method.

With the straight line method the premium/discount is amortized linearly over the duration of the bond.

**Example (continued)**

The firm is issuing a 100 bonds, each with a 1,000 face value with a maturity of 5 years and nominal interest of 8%. At the day the bond issue is settled, investors are willing to pay 102% of the face value, i.e. 1,020 for each bond. The value of 1,020 corresponds with an effective interest rate of 7.5%.

The journal entry of issuing the bond (numbers are rounded):

|  |  |  |  |
| --- | --- | --- | --- |
| T-account | Debit | Credit |  |
| Cash | 102,000 |  |  |
| Bond payable |  | 100,000 |  |
| Bond premium |  | 2,000 |  |

The yearly journal entry for the interest payment:

|  |  |  |  |
| --- | --- | --- | --- |
| T-account | Debit | Credit |  |
| Interest expense | 7,600 |  |  |
| Bond premium | 400 |  |  |
| Cash |  | 8,000 |  |

\*400 = 2,000 / 5 years

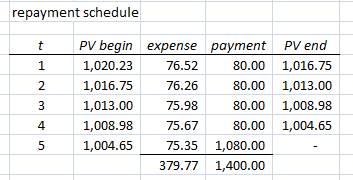
When the effective interest method is used, the bond remains valued over the duration of the bond at the present value of the interest payments and repayment at maturity.

It is helpful to make a repayment schedule, to highlight the difference between the interest payment and interest expense over time. The repayment schedule will show for each year the beginning of year present value of the bond, the interest expense (= effective interest rate x beginning of year present value), the interest payment (=nominal interest rate x nominal value) and the end of the period present value of the bond(=beginning value + interest expense – interest payment).

In case of a premium, in each period, the interest expense will be less than the interest payment. Similarly, in case of a discount, the interest expense will be greater than the interest payment. Regardless whether there is a premium or discount, at maturity, all of the premium/discount will have been allocated.

**Example (continued)**

The firm is issuing a 100 bonds, each with a 1,000 face value with a maturity of 5 years and nominal interest of 8%. At the day the bond issue is settled, investors are willing to pay 102% of the face value, i.e. 1,020 for each bond. The value of 1,020 corresponds with an effective interest rate of 7.5%.



The expense is computed as the beginning of year present value multiplied by the effective interest rate. The interest payments and repayment are dictated by the terms of the bond.

The journal entry of the first year’s interest payment (for the 100 bonds in total):

|  |  |  |  |
| --- | --- | --- | --- |
| T-account | Debit | Credit |  |
| Interest expense | 7,652 |  |  |
| Bond premium | 348 |  |  |
| Cash |  | 8,000 |  |

The journal entry of the last year’s interest payment and repayment of the nominal value:

|  |  |  |  |
| --- | --- | --- | --- |
| T-account | Debit | Credit |  |
| Bond | 100,000 |  |  |
| Interest expense | 7,535 |  |  |
| Bond premium | 465 |  |  |
| Cash |  | 108,000 |  |

Note that the sum of the total interest expense (379,77)  equals the total interest payments (400) minus the premium (20.23), which is received at time of issue, but does not have to be repaid.

When a bond is callable, the firm has the right (not the obligation) to repay the bond at an earlier point in time than the maturity date. This option has value for the firm when interest rates have declined. In this case, the firm can lower its interest expenses by repaying the bond with the proceeds of a new bond. Bondholders, however, will require to be compensated for allowing the firm to have such an option. The terms of the bond will therefore include a penalty to be paid by the firm to the bondholders when the firm calls the bond.

Key points:  
- the firm can issue a bond to fund their operations; bondholders pay for the bond in return for interest payments and repayment of the principal at maturity  
- the nominal interest rate is used to compute the interest payments  
- investors use the market interest rate to price the bond at issue, the resulting issue price implies an effective interest rate on the bond  
- the effective interest rate is only equal to the nominal interest rate if the issue price equals the nominal value  
- the effective interest rate is the return that bondholders will make if they hold until maturity (and the firm does not default); it is also the interest expense for the firm  
- if the effective interest rate is lower than the nominal interest rate (used to compute the interest payments), investors are willing to pay a premium for the bond at time of issue  
- if the effective interest rate is higher than the nominal interest rate (used to compute the interest payments), investors are demanding a discount in order to buy the bond at time of issue  
- the premium/discount are recorded at a contra T-account to bond payable and are amortized over the term of the bond  
- the straight line method amortizes the premium/discount in yearly equal amounts  
- the effective interest method amortizes the premium/discount so that the carrying value of the bond equals the present value of the

remaining interest payments and repayment at maturity

**Financial lease**

With lease, a firm uses the asset which (legally) belongs to another party. Accounting-wise, we distinguish between short term lease, or operating lease, and long term lease, which is called financial lease (also called finance lease, or capital lease). The primary differentiating factor is that with financial lease, the risks (and rewards) are with the firm which is leasing, because the lease is long term and cannot be cancelled.

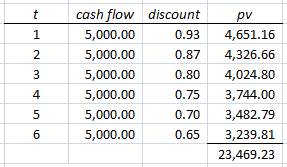
Application of the ‘substance over form’ principle, meaning that the economic reality (having the risks and rewards) is more important than the legal reality (not having legal ownership), has resulted in a difference in accounting treatment for operating lease versus financial lease.

With operating lease, the lease payments are expensed in the period where the asset is used (which is usually the period is which the lease term is paid). With financial lease, when the contract is signed, the firm recognizes an asset as well as a liability for the present value of the lease payments. The lease terms will include interest and repayment. As the lease terms are paid, interest expense is booked and the liability is repaid. The asset is depreciated over the economic lifetime.

**Example**

The firm has entered a long-term lease contract for a machine. The lease term is six years. Annually, the firm will pay 5,000 at the end of each year. The effective interest rate is 7.5%.

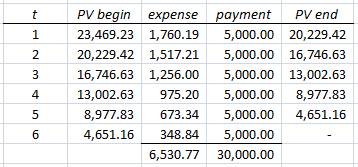
The present value of the payments is 23,469.23.



When the contract is signed, the firm makes the following journal entry:

|  |  |  |  |
| --- | --- | --- | --- |
| T-account | Debit | Credit |  |
| Machines | 23,469.23 |  |  |
| Lease obligations |  | 23,469.23 |  |

The repayment schedule is as follows:



Liabilities increase with (effective) interest, and are reduced with payments. Thus, the interest expense in the first year is 1,760.19, and the payment is 5,000. Hence, the liability reduces with the difference of 3,239.81.

For the first payment the following journal entry is made:

|  |  |  |  |
| --- | --- | --- | --- |
| T-account | Debit | Credit |  |
| Interest expense | 1,760.19 |  |  |
| Lease obligations | 3,239.81 |  |  |
| Cash |  | 5,000 |  |

Also, the asset is depreciated over its economic lifetime. Using straight line depreciation and assuming no residual value results in a yearly depreciation expense of 23,469.23 divided by six years equals 3,911.54 per year.

|  |  |  |  |
| --- | --- | --- | --- |
| T-account | Debit | Credit |  |
| Depreciation expense | 3,911.54 |  |  |
| Accumulated depreciation machine |  | 3,911.54 |  |

Currently, accounting principles have a cut-off point between operating lease and financial lease. If the (un-cancellable) term is at least 75% of the economic lifetime, the present value of the lease terms at least 90% of the purchase price of the asset, or the lease contract includes a provision by which the asset can be bought at the end of the term for a symbolic amount, then the lease is considered finance lease. However, currently the FASB and IASB (standard setting bodies of US GAAP and IFRS, respectively) are working on new accounting regulation where operating lease will be treated as financial lease.

**Key points**:  
- operational lease is a short term lease; lease payments are expensed in the period of usage (usually the period of the lease payment)  
- financial lease (or, finance lease, capital lease) is a long term non-cancellable lease, where the risks and rewards are with the firm that leases the asset, and not the leasing-firm which has the legal ownership  
- with financial lease, following the substance-over-form principle, the firm which leases the asset will capitalize the asset and show the present value of the lease obligations as a liability  
- during the lease term, the lease obligation increases with interest (which is an expense) and is reduced with the lease payments   
- currently, the accounting principles determine that a lease is financial when (1) the (non-cancellable) term of the lease is at least 75% of the economic lifetime, (2) the present value of the lease payments is 90% or more of the purchase price of the asset, or (3) at the end of the lease legal ownership is transferred for a symbolic (small) price  
- new regulation for US GAAP and IFRS is expected in 2011, when operating lease will be treated like financial lease (capitalization of the asset, and recognizing the lease liability)