Current Liabilities and Employer Obligations

Part 1

Your goals for this "current liabilities" chapter are to learn about:

- The nature and recording of typical current liabilities.
- Accounting for notes payable.
- The criteria for recognition and/or disclosure of contingent liabilities.
- Basic accounting for payroll and payroll related taxes.
- Other components of employee compensation (e.g. vacation pay, pensions, and so forth).

1. Current Liabilities

The current liabilities section of the balance sheet contains obligations that are due to be satisfied in the near term, and includes amounts relating to accounts payable, salaries, utilities, taxes, short-term loans, and so forth. This casual description is inadequate for all situations, so accountants have developed a very specific definition to deal with more issues. Current liabilities are debts that are due to be paid within one year or the operating cycle, whichever is longer; further, such obligations will typically involve the use of current assets, the creation of another current liability, or the providing of some service. This enhanced definition is expansive enough to capture less obvious obligations pertaining to items like customer prepayments, amounts collected for and payable to third parties, the portion of long-term debt due within one year or the operating cycle (whichever is longer), accrued liabilities for expenses incurred but not yet paid, and contingent liabilities. However, the definition is not meant to include amounts not yet "incurred." For example, salary to be earned by employees next year is not a current liability (this year) because it has yet to be "incurred."

1.1 The Operating Cycle

Remember that the operating cycle is the length of time it takes to turn cash back into cash. That is, a business starts with cash, buys inventory, sells goods, and eventually collects the sales proceeds in cash. The length of time it takes to do this is the operating cycle. Take careful note of how the operating cycle is included in the above definition of current liabilities: "one year or the operating cycle, whichever is longer." For most businesses, the operating cycle is less than one year, but not always. A furniture manufacturer may have to buy and cure wood before it can be processed into a quality product. This could cause the operating cycle to go beyond one year. If that is the case, then current liabilities might include obligations due in more than one year.

1.2 Illustrations of Typical Current Obligations

Accounts Payable are the amounts due to suppliers relating to the purchase of goods and services. This is perhaps the simplest and most easily understood current liability. Although an account payable may be supported by a written agreement, it is more typically based on an informal working relation where credit has been received with the expectation of making payment in the very near term.

Notes Payable are formal short-term borrowings usually evidenced by a specific written promise to pay. Bank borrowings, equipment purchases, and some credit purchases from suppliers involve such instruments. The party who agrees to pay is termed the "maker" of the note. Properly constructed, a note payable becomes a negotiable instrument, enabling the holder of the note to transfer it to someone else. Notes payable typically involve interest, and their duration varies. When a note is due in less than one year (or the operating cycle, if longer), it is commonly reported as a current liability.

The Current Portion of Long-term Debt is another frequently encountered current obligation. When a note or other debt instrument is of long duration, it is reported as a long-term liability. However, the amount of principal which is to be paid within one year or the operating cycle, whichever is longer, should be separated and classified as a current liability. For example, a $100,000 long-term note may be paid in equal annual increments of $10,000, plus accrued interest. At the end of any given year, the $10,000 principal due during the following year should be reported as a current liability (along with any accrued interest), with the remaining balance shown as a long-term liability.

Accrued Liabilities (sometimes called accrued expenses) include items like accrued salaries and wages, taxes, interest, and so forth. These items relate to expenses that accumulate with the passage of time, but will be paid in one lump-sum amount. For example, the cost of employee service accrues gradually with the passage of time. The amount that employees have earned but not been paid is termed accrued salaries and should be reported as a current liability. Likewise, interest on a loan is based on the period of time the debt is outstanding; it is the passage of time that causes the interest payable to accrue. Accrued but unpaid interest is another example of an accrued current liability.

Prepayments by Customers arise from transactions such as selling magazine subscriptions in advance, selling gift-cards, selling tickets well before a scheduled event, and other similar items where the customer deposits money in advance of receiving the expected good or service. These items represent an obligation on the part of the seller to either return the money or deliver a service in the future. As such, the prepayment is reported as “unearned revenue” within the current liability section of the balance sheet. Recall, from earlier chapters, that the unearned revenue is removed and revenue is recognized as the goods and services are provided. In some cases, customers may never redeem a gift-card. In this situation, it would generally be appropriate to derecognize the liability and record revenue once it is viewed as remote that the card will ever be redeemed and the company has no obligation to remit funds to some governmental jurisdiction (as is sometimes required by law). Collections for Third Parties arise when the recipient of some payment is not the beneficiary of the payment. As such, the recipient has an obligation to turn the money over to another entity. At first, this may strike you as odd. But, consider sales taxes. The seller of merchandise must collect the sales tax on transactions, but then has a duty to pass those amounts along to the appropriate taxing entity. Such amounts are appropriately reflected as a current liability until the funds are remitted to the rightful owner.

Obligations to be Refinanced deserve special consideration. A long-term debt may have an upcoming maturity date within the next year. Ordinarily, this note would be moved to the current liability section. However, companies often simply renew such obligations, in essence, borrowing money to repay the maturing note. This poses an interesting question -- should currently maturing long-term debt be shown as a current or a long-term liability if it is going to be renewed by simply rolling the debt into a replacement long-term obligation? What financial statement is fair -- to show the debt as current even though it will not be a claim against current assets -- or to show the debt as long-term even though it is now due? To resolve this issue, accountants have very specific rules: a currently maturing long-term obligation is to be shown as a current liability unless (1) the company intends to renew the debt on a long-term basis, and (2) the company has the ability to do so (ordinarily evidenced by a firm agreement with a competent lender).