General Points

Liabilities are present obligations for either the future payment of assets or the future performance of services that result from past transactions.

A liability generally should be recorded when an obligation arises, but it is also necessary to make end-of-period adjustments for accrued and estimated liabilities.

Liabilities are valued at the actual or estimated amount due, or at the fair market value of goods or services that must be delivered.

Current Liabilities are present obligations that are expected to be satisfied within one year or the normal operating cycle, whichever is longer. Payment is expected to be out of current assets or by taking on another current liability.

Long-term Liabilities are obligations that are not expected to be satisfied in the current period.

Additional disclosure of liabilities may be required in the notes to the financial statements for such things as: an explanation of special credit arrangements, interest rates, dates of maturity, lines of credit, etc.

In accounting for liabilities, organizations must answer 3 questions:

1. Whom to pay?

2. When to pay?

3. How much to pay?

Sometimes the answers to these questions are difficult to determine exactly and must be estimated.

Definitely determinable liabilities

Definitely determinable liabilities are obligations that can be measured exactly. They include:

1. accounts payable

2. short-term notes payable (Notes may be issued with the interest stated separately or as a part of the face value on the note. The account “ Discount on Notes Payable is used as a contra account to Notes Payable in the case of interest included in the face value of the note.)

Journal entries for interest stated separately:

When issued: Cash

Notes Payable

When paid: Notes Payable

Interest Expense

Cash

Accrual: Interest Expense

Interest Payable

When Paid

(After Accrual): Interest Payable

Interest Expense

Notes Payable

Cash

3. dividends payable (obligations to distribute the earnings of a corporation to the stockholders)

4. sales and excise taxes payable (merchants must collect these taxes at the time of sale and would record both the receipt of cash and the proper tax liabilities)

5. current portions of long-term debt

6. accrued liabilities (liabilities that exist at the balance sheet date but are unrecorded)

7. payroll liabilities (Not only is a business responsible for paying wages, paid at an hourly rate, and salaries, paid at a monthly or yearly rate, earned by its employees, it must pay social security taxes, Medicare, and unemployment taxes. Withholdings are also made for pension plans, insurance premiums, union dues, and savings plans.)

The employer is required by law to withhold certain taxes from the employee’s earnings and to send those taxes to government agencies. Federal and state income taxes depend on the amount the employee earns and the number of exemptions claimed on the employee’s W-4 form.

8. unearned revenues (obligations to deliver goods or services in return for advance payment)

Estimated Liabilities

Estimated Liabilities are definite obligations but the amount of the obligation must be estimated at the balance sheet date because the exact figure will not be known until a future date. Examples include:

1. Income Taxes (A corporation’s income tax depends on its net income, a figure that often is not determined until after the balance sheet date.)

2. Property Taxes (Very often a company’s accounting period ends before property taxes have been assessed so an estimate must be made.)

3. Warranties (When a company sells its products, many of the warranties will still be in effect during subsequent accounting periods. However, the warranty expense and liability must be recorded in the period of the sale no matter when the company makes good on the warranty.) The journal entry would be:

Product Warranty Expense

Estimated Product Warranty Liability

When the warranty obligation is fulfilled by **replacement**, the journal entry would be:

Estimated Product Warranty Liability

Merchandise Inventory

When the warranty obligation is fulfilled by **repairing** the merchandise, the journal entry would be:

Estimated Product Warranty Liability

Repair Parts [or Wages Payable]

4. Vacations (In most companies an estimate must be made of the vacation pay that applies to each payroll period. The liability decreases when an employee receives vacation pay.) The journal entry would be:

Contingent Liabilities

Contingent Liabilities are potential liabilities that may or may not become an actual liability. Two conditions must be met when a contingency is entered into the accounting records:

1. The liability must be probable.

2. The liability must be reasonably estimated.

Contingent liabilities arise from things like: pending lawsuits, tax disputes, discounted notes receivable, the guarantee of another company's debt, and failure to follow government regulations.

Supplemental Topic: Allocating Revenue

When the amount of revenue received or the timing of the earning of the revenue is not clear-cut, there are four ways to allocate revenue to different accounting periods.

1. Sales Method : All revenue is recognized at the beginning of the contract for services/products with a journal entry such as the following (using the perpetual system):

Accounts Receivable

Sales Revenue

Cost of Goods Sold

Merchandise Inventory

Similar entries would be made if using the other methods. However, the amount of sales revenue recognized would differ.

2. Installment Method : In an installment sale, the buyer makes a down payment when the contract is signed and makes additional periodic payments over time. Revenue is recognized a little at a time by paralleling installment payments received. This method postpones recognition of revenue earned and therefore also postpones taxes paid on the revenue earned. The amount of revenue to be recognized is calculated as follows:

Find the *Gross Profit Percentage*: Gross Profit**

Total Sales (in installments)

Multiply the *Gross Profit Percentage* by each installment collection to find revenue to be recognized.

[**Remember that Gross Profit = Sales – COGS]

3. Percent of Completion Method : In this method, revenue is recognized a little at a time by paralleling cost completion. For example, if a one-year project costs $100,000 and $50,000 of costs are incurred in year one, then 50% of the revenue should be recognized in year one. To calculate the percentage of revenue to be recognized:

Current Year's Cost = % Completion

Total Project Cost

% Completion x Total Project Revenue = Revenue to be Recognized

Collection Method : Revenue is recognized under this method when the cash is received. Usually this occurs after services have been performed or goods delivered.