

MBA in Food & Agribusiness

Financial Management

Current Liabilities

Why Current Liabilities?



Creditors force Ply Mart into bankruptcy



Wednesday, July 2, 2008 Atlanta Business Chronicle - by [Lisa R. Schoolcraft](#) Staff Writer

Three **major creditors** of [Ply-Marts Inc.](#), one of metro Atlanta's top lumber suppliers, have filed a petition **to force the company into involuntary bankruptcy** over some \$1.2 million in debt. Ply Mart had **defaulted on a revised loan agreement** in early 2008 and again on June 3, the bank's petition to the court said.

Ply Mart had [taken steps](#) to weather the slumping housing market, slashing its staff, putting its real estate on the market, and closing many of its locations.

Current Liabilities

- Management issues related to current liabilities
- Common types of current liabilities
- Contingent liabilities and commitments

Classification

Current Liabilities

Debts and obligations that a company expects to satisfy **within one year** or within its **normal operating cycle**, whichever is longer

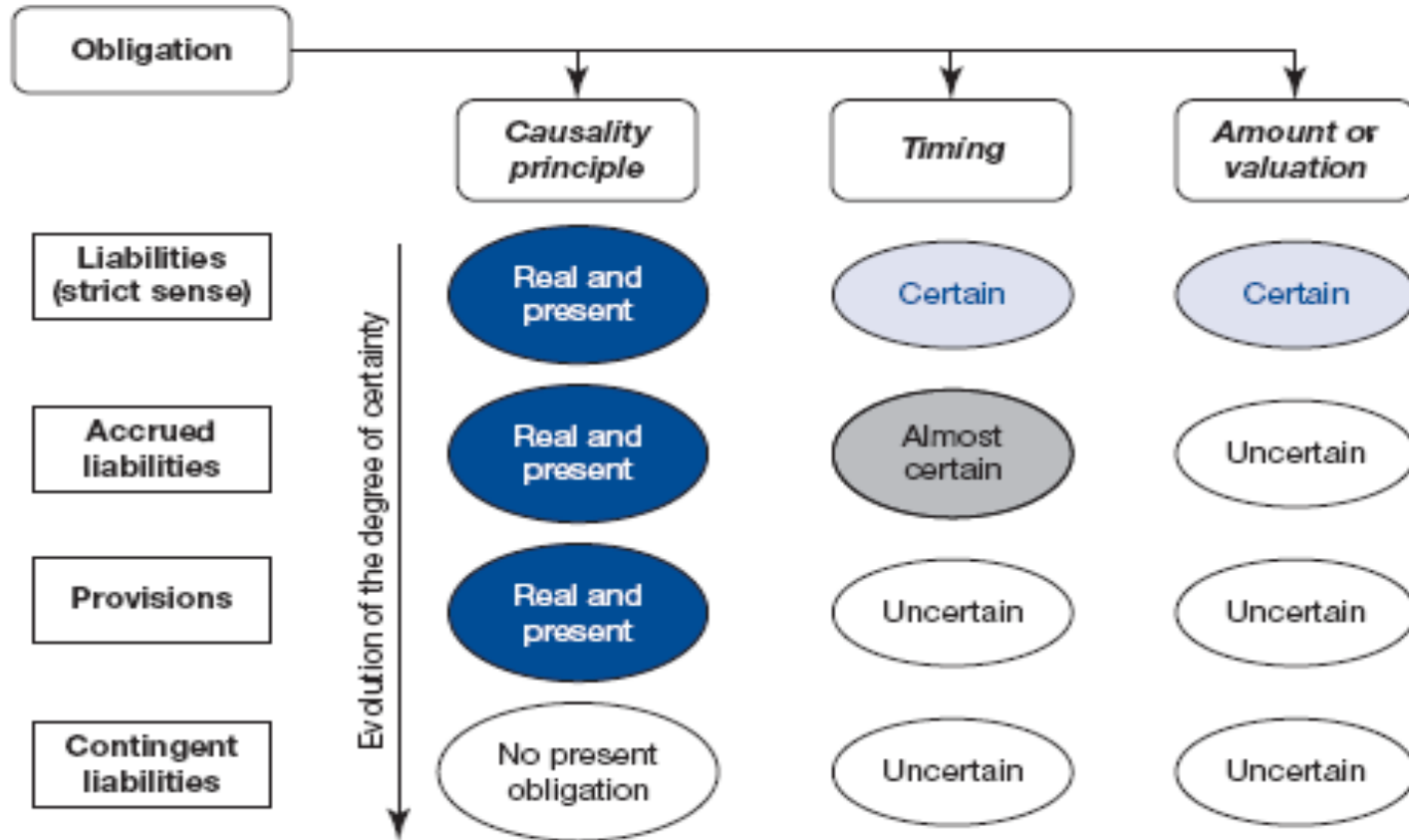
2 Types:

- Definitely Determinable
- Estimated

Long-Term Liabilities

Due beyond one year or beyond the normal operating cycle

Liabilities and related concepts (IAS 37)



Common Types of Current Liabilities

Definitely Determinable Liabilities: Current liabilities that are set by contract or statute and that **can be measured exactly**



- Accounts Payable
- Bank loans and commercial paper
- Notes payable
- Accrued liabilities
- Dividends payable
- Sales and excise taxes payable
- Current portion of long-term debt
- Payroll liabilities
- Unearned revenues

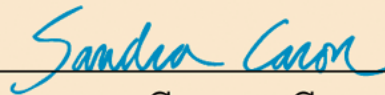
Short-Term Notes Payable

Obligations represented by promissory notes

Chicago, Illinois

August 31, 20xx

Sixty days after date I promise to pay First Federal Bank
the sum of \$5,000 with interest at the rate of 12% per
annum.



Caron Corporation

Recording Notes Payable

Issuance of 60-day, 12 percent promissory note on August 31

Aug. 31	Cash	5,000	
	Notes Payable		5,000
	Issued 60-day, 12 percent promissory note		

Payment of note

Oct. 30	Notes Payable	5,000.00	
	Interest Expense	98.63	
	Cash		5,098.63
	Payment of promissory note with \$100 interest		

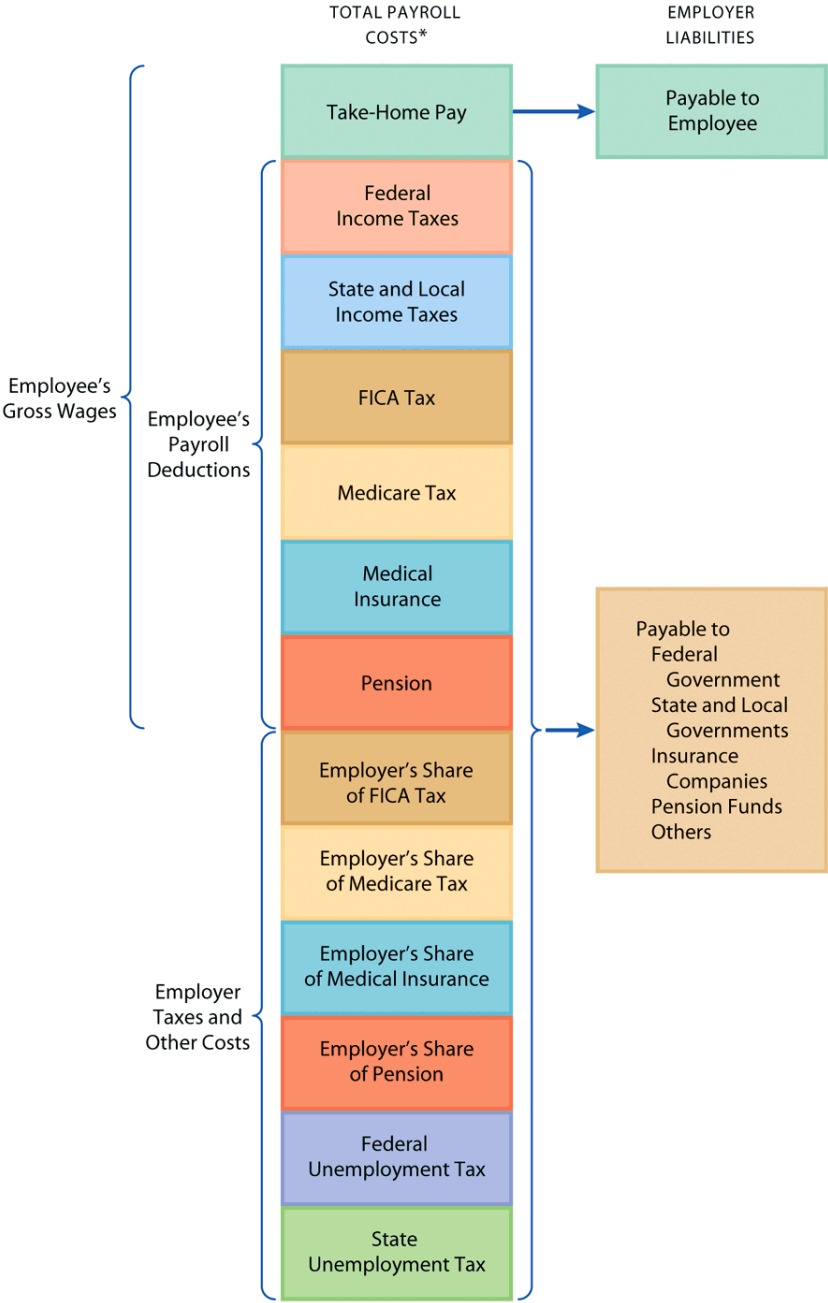
$$\$5,000 \times .12 \times \frac{60}{365} = \$98.63$$

Payroll Liabilities

Cost of labor	Salaries & Wages
Payroll taxes	USA: FICA, Medicare, FUTA, and SUTA

Employers are responsible to various government agencies and other entities for amounts withheld

Payroll Costs



*Boxes are not proportional to amounts.

Recording Payroll

Feb. 15: Record payroll, total employee wages, \$32,500

Feb.15	Wages Expense	32,500	
	Employees' Federal Income Taxes Payable		5,400
	Employees' State Income Taxes Payable		1,200
	Social Security Tax Payable		2,015
	Medicare Tax Payable		471
	Medical Insurance Premiums Payable		900
	Pension Contributions Payable		1,300
	Wages Payable		21,214
	To record payroll		

Note that employees earned \$32,500 but their take home pay was only \$21,214

Recording Payroll

Feb. 15: Record payroll taxes and benefit costs

Feb.15	Payroll Taxes and Benefits Expense	9,401	
	Social Security Tax Payable		2,015
	Medicare Tax Payable		471
	Medical Insurance Premiums Payable		3,600
	Pension Contributions Payable		1,300
	Federal Unemployment Tax Payable		260
	State Unemployment Tax Payable		1,755
	To record payroll taxes and other costs		

Payroll taxes and benefits increase the total cost of payroll to \$41,901

Common Types of Current Liabilities

Estimated Liabilities (Provisions) definite obligations whose **exact dollar amount cannot be known until a later date**

Estimate
and record
these types
of liabilities

- ✓ Income taxes
- ✓ Property taxes
- ✓ Promotional costs
- ✓ Product warranties
- ✓ Vacation pay

Product Warranty Liabilities

When a firm sells a product or service with a warranty, it has a liability for the length of the warranty

Illustration:

Midas Muffler guarantees that it will replace free of charge any muffler it sells that fails during the time the buyer owns the car. In the past, 6 percent of mufflers sold have been returned for replacement. The average cost for a muffler is \$50. If the company sold 350 mufflers during July, what is the amount of liability to be accrued?

$$350 \times .06 = 21 \times \$50 = \$1,050$$

Recording Product Warranty Liabilities

Record warranty expense:

July 31	Product Warranty Expense	1,050	
	Estimated Product Warranty Liability		1,050
	To record estimated product warranty expense		

Record replacement of a defective muffler, which cost \$40, and receipt of \$20 service fee to have it replaced:

Dec. 5	Cash	20	
	Estimated Product Warranty Liability	40	
	Service Revenue		20
	Merchandise Inventory		40
	Replacement of muffler under warranty		

Contingent Liabilities and Provisions (IAS 37)

Conditions for determining when a liability should be entered in the accounting records:

1. The company should have a present obligation as a result of a past event.
2. The liability must be probable
3. The liability can be reasonably estimated
(eg warranty liability)

= Provision

Contingent Liabilities and Provisions (IAS 37)

Potential liabilities that **depend on future events** not controlled by the company arising out of past transactions



Do not recognise in balance sheet only disclose

Payables Turnover

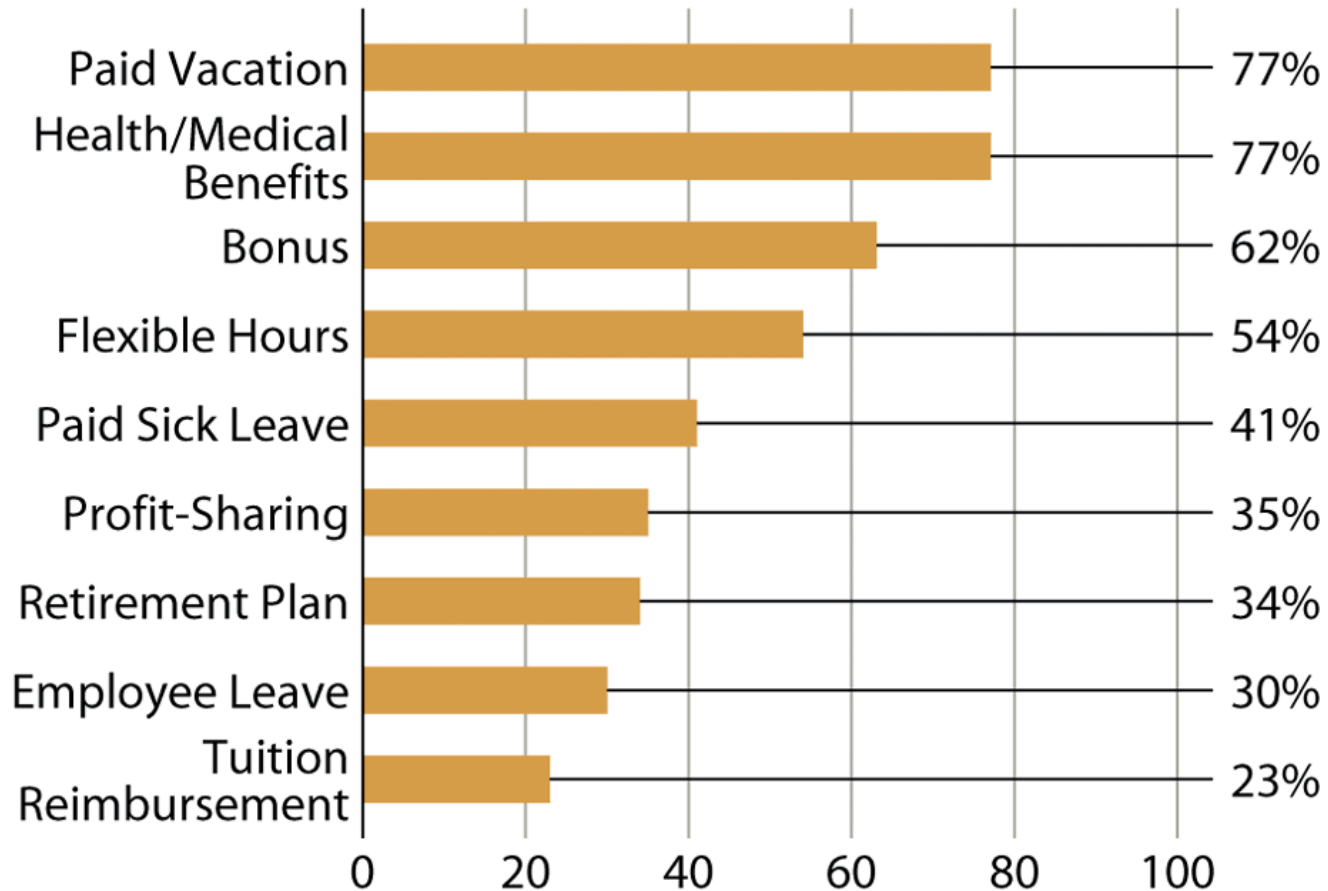
Number of times, on average, that a company pays its accounts payables in an accounting period

$$\text{Payables Turnover} = \frac{\text{Cost of Goods Sold} \pm \text{Change in Merchandise Inventory}}{\text{Average Accounts Payable}}$$

$$\begin{array}{l} \text{Amazon.com's} \\ \text{2004 Payables} \\ \text{Turnover} \end{array} = \frac{\$5,319,127 + \$185,792}{(\$1,141,733 + \$819,811) \div 2}$$

5.6 times

Payables Turnover for Selected Industries



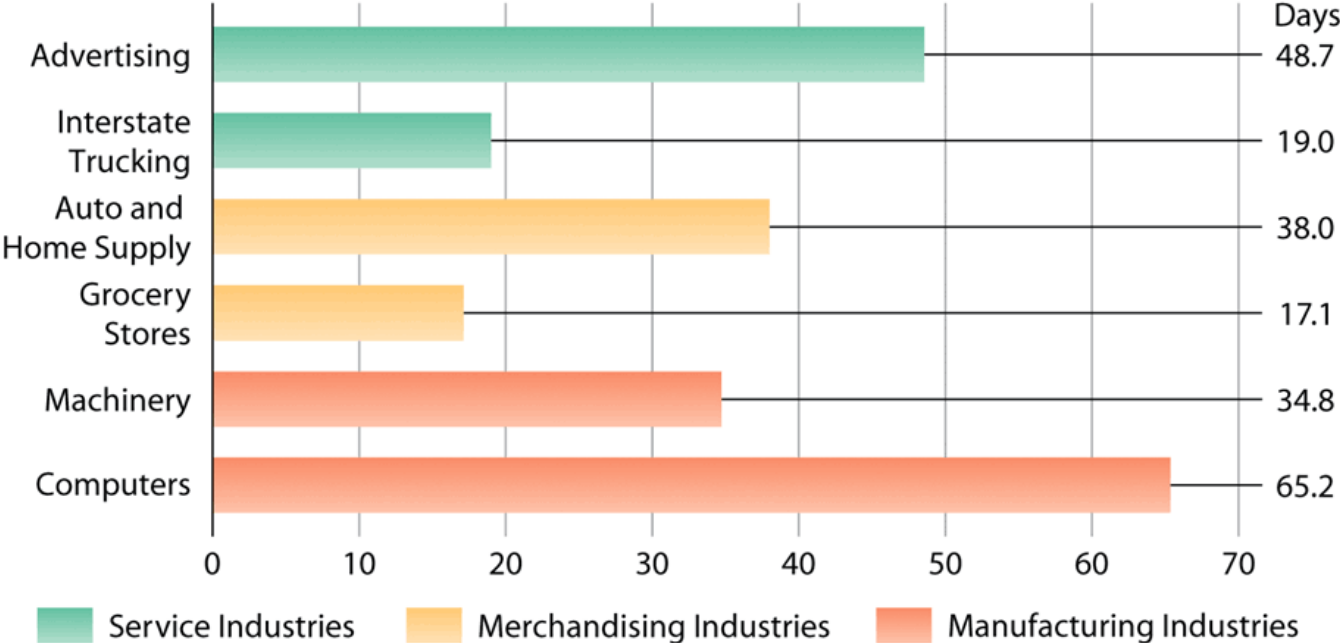
Days' Payable

How long, on average, a company takes to pay its accounts payables

$$\text{Days' Payable} = \frac{365 \text{ days}}{\text{Payables Turnover}}$$

$$\begin{aligned} \text{Amazon.com's} & \quad \frac{365 \text{ days}}{\text{Days' Payable} = 5.6} \\ & = 65.2 \text{ days} \end{aligned}$$

Days' Payable for Selected Industries



Long-Term Assets (IAS 16)

Why Long-Term Assets?

Table 7.1 Weight of tangible assets

Company (country – activity)	Currency	Tangible assets (net amount)	Total assets (net amount)	% of total assets	Depreciation expense	Sales	% of sales
Irish Continental (Ireland – Shipping, transport)	€m	320	377	84.9	25	293	8.5
Stora-Enso (Finland – Paper production)	€m	9,755	16,412	59.4	1,172	12,396	9.5
China Petroleum & Chemical Corporation (China – Oil and chemistry)	RMBm	270,136	460,081	58.7	30,766	397,789	7.7
Club Méditerranée (France – Leisure)	€m	761	1,482	51.3	431	9,690	4.4
Repsol (Spain – Oil and gas)	€m	19,677	38,943	50.5	2,396	40,585	5.9
Heineken (Netherlands – Brewery group)	€m	5,127	10,418	49.2	773	10,005	7.7
Temple-Inland (USA – Paper packaging products)	\$m	1,843	4,638	39.7	238	3,501	6.8
Elkem (Norway – Metals and materials [production])	NOKm	7,252	18,951	38.3	936	22,043	4.2
Interbrew (Belgium – Brewery group)	€m	5,298	18,596	28.5	621	8,568	7.2

Long-Term Assets

- Management issues related to Long-term assets
- Acquisition cost of property plant and equipment
- Depreciation
- Disposal of Depreciable assets
- Natural resources
- Intangible assets

Acquisition Cost of Property, Plant and Equipment

Payments for an asset



Capital Expenditure

Expenditure for the **purchase or expansion of a long-term asset = *Obtaining* future economic benefits**

Revenue Expenditure

Expenditure for the repair, maintenance, and operation of a long-term asset = *maintaining* future economic benefits

Acquisition Costs

IAS 16 §16 Includes all expenditures reasonable and necessary to get an asset in place and ready for use:

- **Purchase price** including import duties and deducting trade discounts
- **Directly attributable cost** e.g. delivery, testing, professional fees
- **Dismantling** and removing cost

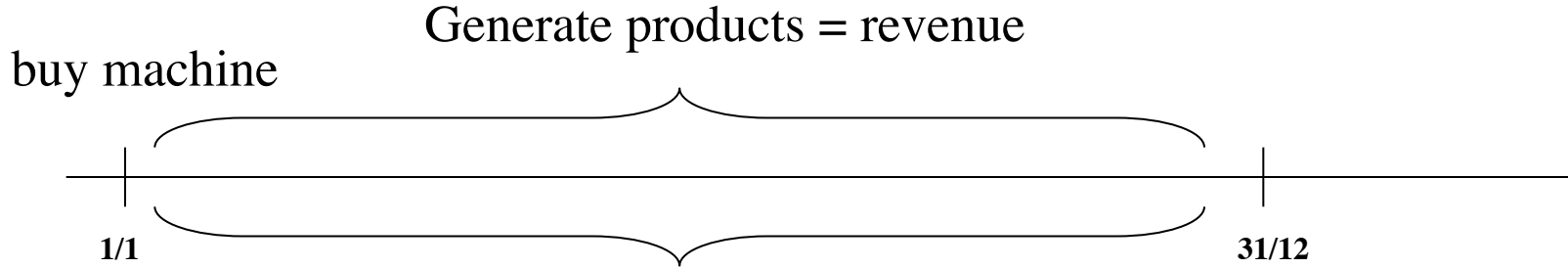
§1.4 Cost of Acquisition

Bob purchased a piece of equipment on 4 April 20x8 incurring the following cost:

- List price of the Machine € 8,550
- Trade discount € 855
- Delivery cost € 105
- Set up cost performed by employee € 356

At what cost should Bob recognize his machine?

The Matching Rule and Long-Term Assets



No cost to MATCH?

= depreciation, reduction in value of machine on the balance sheet due to using the machine to generate economic benefits.

Carrying Value

$$\begin{aligned} & \text{Unexpired Cost or Net book Value} \\ & = \text{Cost} - \text{Accumulated Depreciation} \end{aligned}$$

On the Balance Sheet:

Plant Assets

Less Accumulated Depreciation

Carrying Value

Natural Resources

Less Accumulated Depletion

Carrying Value

Intangible Assets

Less Accumulated Amortization

Carrying Value

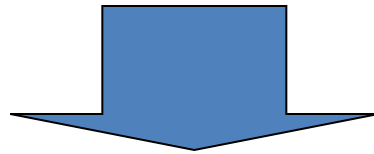
What Is Depreciation?

The periodic allocation of the cost of a tangible asset over the asset's estimated useful life

- ✓ All tangible assets **except land** have a limited useful life (physical deterioration and obsolescence limit useful life)
- ✓ Depreciation refers to the allocation of the cost of a plant asset **to the periods that benefit from the asset**, not to the asset's physical deterioration or decrease in market value
- ✓ Depreciation is not a process of valuation; it is a process of **allocation**

Accounting for Depreciation

Depreciation is recorded at the end of the accounting period by an adjusting entry



Depreciation Expense, Asset Name	xxx	
Accumulated Depreciation, Asset Name		xxx
To record depreciation for the period		

Asset devaluation account

Methods of Accounting for Depreciation

Straight-line method	Spreads the depreciable cost evenly over the estimated useful life of the asset
Production method H/W	Based on the assumption that depreciation is solely the result of use and that passage of time plays no role in the depreciation process
Declining-balance method	Accelerated method of depreciation that results in larger amounts of depreciation in earlier years of the asset's life and smaller amounts in later years

Straight-Line Method Illustrated

A delivery truck costs \$10,000 and has an estimated residual value of \$1,000 at the end of its estimated useful life of 5 years.

$$\begin{aligned}\text{Yearly Depreciation} &= \frac{\text{Cost} - \text{Residual Value}}{\text{Estimated Useful Life}} \\ &= \frac{\$10,000 - \$1,000}{5 \text{ years}} = \$1,800 \text{ per year}\end{aligned}$$

Depreciation Schedule, Straight-Line Method

	Cost	Yearly Depreciation	Accumulated Depreciation	Carrying Value
Date of purchase	\$10,000	—	—	\$10,000
End of first year	10,000	\$1,800	\$1,800	8,200
End of second year	10,000	1,800	3,600	6,400
End of third year	10,000	1,800	5,400	4,600
End of fourth year	10,000	1,800	7,200	2,800
End of fifth year	10,000	1,800	9,000	1,000

The amount of depreciation is the same each year

Accumulated depreciation increases uniformly

The carrying value decreases uniformly until it reaches the estimated residual value

Double-Declining-Balance Method Illustrated

A delivery truck costs \$10,000 and has an estimated residual value of \$1,000. Its estimated useful life is 5 years.

Under the straight-line method, the depreciation rate for each year is 20 percent:

$$100 \text{ percent} \div 5 \text{ years} = 20 \text{ percent}$$

Under the double-declining-balance method, the depreciation rate for each year is 40 percent:

$$2 \times 20 \text{ percent} = 40 \text{ percent}$$

This fixed rate is applied to the **remaining carrying value** at the end of each year.

Depreciation Schedule, Double-Declining-Balance Method

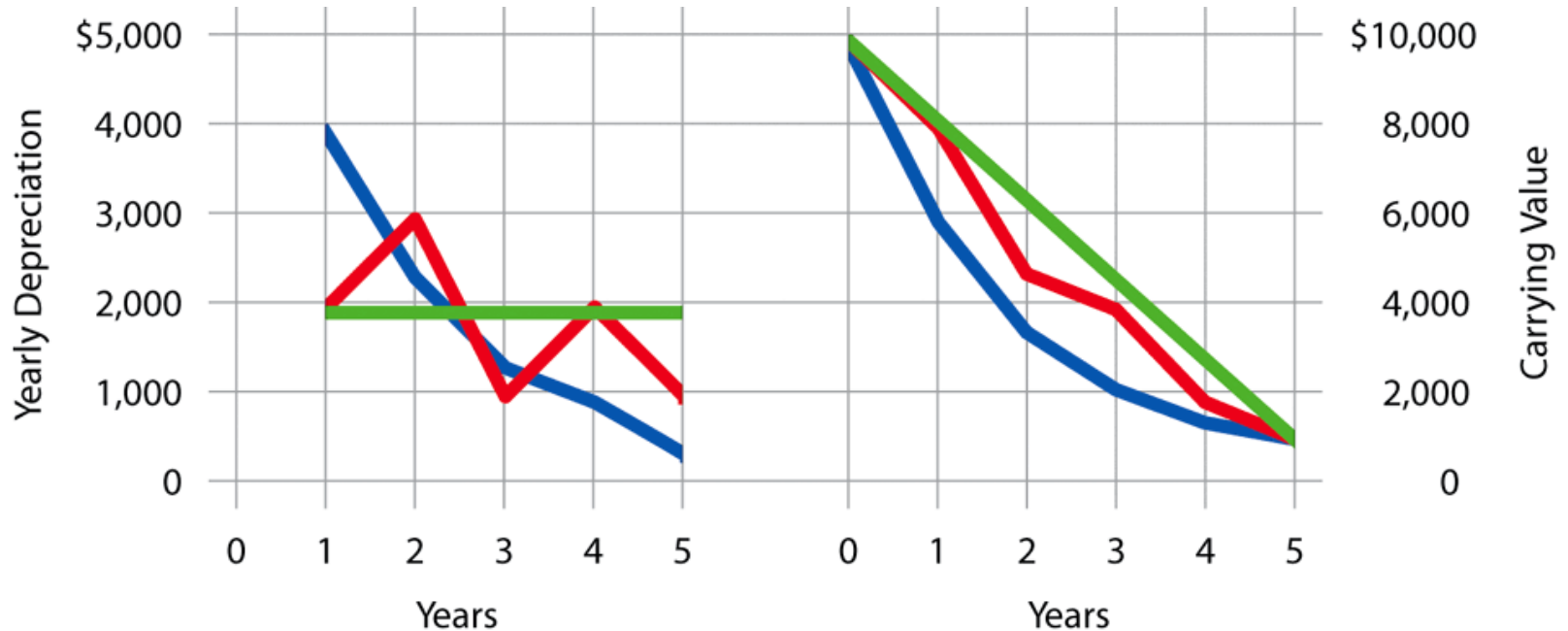
	Cost	Yearly Depreciation	Accumulated Depreciation	Carrying Value
Date of purchase	\$10,000		—	\$10,000
End of first year	10,000	(40% x \$10,000)	\$4,000	6,000
End of second year	10,000	(40% x \$6,000)	2,400	3,600
End of third year	10,000	(40% x \$3,600)	1,440	2,160
End of fourth year	10,000	(40% x \$2,160)	864	1,296
End of fifth year	10,000		296	1,000

Note that the fixed rate is always applied to the **carrying value at the end of the previous year.**

Depreciation is greatest in the first year and declines each year after that.

The **depreciation in the last year is limited** to the amount necessary to reduce the carrying value to the residual value.
 (\$1,296 - \$1,000 = \$296)

Graphic Comparison of Three Methods of Determining Depreciation



Methods

— Straight-line
 — Production
 — Double-declining-balance

Disposal of a Depreciable Asset

MGC Company purchased a machine on January 2, 20x2, for \$6,500 and planned to depreciate it on a straight-line basis over its estimated useful life (8 years). Its residual value at the end of 8 years was estimated to be \$300.

On December 31, 20x7, the balances of the relevant accounts were:

<u>Machinery</u>	<u>Accumulated Depreciation, Machinery</u>
6,500	4,650

$(\$6,500 - \$300/8 \text{ years}) * 6 \text{ years}$

Disposal of a Plant Asset

On January 2, 20x8, management disposed of the asset for \$ 2000 cash.

Jan. 2	Cash	2,000	
	Accumulated Depreciation, Machinery	4,650	
	Gain on Sale of Machinery		150
	Machinery		6,500
	Sale of machinery at more than carrying value; gain of \$150 recorded (\$2,000 – \$1,850)		

Machinery	
6,500	6,500
Bal. -0-	

Accum. Depreciation, Machinery	
4,650	4,650
Bal. -0-	

What Is an Intangible Asset? (IAS 38)

Long-term, **nonphysical** asset whose value comes from the rights or advantages afforded its owner = *having future Economic benefits*

- Goodwill
- Trademarks
- Brand names
- Copyrights
- Patents
- Leaseholds
- Software
- Customer lists



Accounting for Intangible Assets

Intangibles developed by a firm for its own benefit	Intangibles acquired from others
Record as expense	Record as asset; amortize over the shorter of useful life or legal life (not to exceed 40 years)

Intangible Assets Illustrated

Soda Bottling Company purchases a patent on a unique bottle cap for \$18,000. The patent will last for 20 years, but the product using the cap will be sold only for the next six years.

Record the purchase of the patent:

Patents	18,000	
Cash		18,000
To record purchase of bottle cap patent		

Record the annual amortization expense:

Amortization Expense	3,000	
Patents		3,000
To record amortization expense for patent (\$18,000 ÷ 6 years)		

Accounting for Research and Development

IAS 38 § 8:

- **Research:** original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding
- **Development:** application of research findings or other knowledge for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production

Accounting for R&D Expenses or Costs

- **P**robable future econ benefits
- **I**ntention to complete and use/sell asset
- **R**esources adequate and available to complete
- **A**bility to use/sell asset
- **T**echnical feasibility
- **E**xpenditure can be reliable measured