Chapter 10 Study Guide: Liabilities

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1. Introduction to Liabilities

- **Liabilities** are present obligations that arise from past events and are expected to be settled by transferring economic resources, typically cash, at a future date.
- Liabilities can be classified as **current** or **long-term**:
  - **Current Liabilities**: Due within one year or within the company's operating cycle (whichever is longer). Examples: Accounts payable, short-term notes payable, wages payable, and taxes payable.
  - **Long-Term Liabilities**: Due beyond one year. Examples: Long-term notes payable, bonds payable, and pension obligations.

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2. Types of Liabilities

- **Current Liabilities**:
  - **Accounts Payable**: Amounts owed to suppliers for goods and services purchased on credit.
  - **Short-Term Notes Payable**: Written promises to pay a specified amount of money within one year.
  - **Accrued Liabilities**: Expenses that have been incurred but not yet paid, such as wages payable, interest payable, and taxes payable.
  - **Unearned Revenue**: Cash received from customers before goods or services are delivered.
- **Long-Term Liabilities**:
  - **Long-Term Notes Payable**: Loans due beyond one year.
  - **Bonds Payable**: Debt securities issued to investors to raise funds, typically with fixed interest payments over a long period.
  - **Pension Liabilities**: Future obligations related to employee retirement benefits.
  - **Leases**: Long-term agreements that may require future payments, typically for property or equipment.

3. Accounting for Current Liabilities

- **Accounts Payable**:
  - Recognized when goods or services are received.
  - **Journal Entry**:
    - **Debit**: Inventory (or Expense account)
    - **Credit**: Accounts Payable
- **Accrued Liabilities**:
  - Recognized when an expense has been incurred but not yet paid.
  - **Journal Entry** (for wages):
    - **Debit**: Wages Expense
    - **Credit**: Wages Payable
- **Unearned Revenue**:
  - Recognized when cash is received before earning the revenue.
  - **Journal Entry**:
    - **Debit**: Cash
    - **Credit**: Unearned Revenue
- **Short-Term Notes Payable**:
  - Recognized when borrowing occurs through a written agreement.
  - **Journal Entry**:
    - **Debit**: Cash
    - **Credit**: Notes Payable

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4. Accounting for Long-Term Liabilities

- **Long-Term Notes Payable**:
  - Similar to short-term notes but due after one year. Interest payments are typically made periodically, with the principal paid at maturity.
  - **Journal Entry** (at issuance):
    - **Debit**: Cash
    - **Credit**: Notes Payable
- **Bonds Payable**:
  - Bonds are issued to raise large sums of capital. They pay periodic interest (coupon payments) and repay principal at maturity.
  - **Bond Issuance**:
    - **Debit**: Cash
    - **Credit**: Bonds Payable (face value of bonds)
  - **Coupon Payments** (interest payments):
    - **Debit**: Interest Expense
    - **Credit**: Cash
  - **Discount and Premium on Bonds**:

        - If bonds are issued at a **discount** (below face value), the bond discount is amortized over the life of the bond.
        - If bonds are issued at a **premium** (above face value), the bond premium is amortized.

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5. Accounting for Bond Issuance and Amortization

- **Discount on Bonds**:
    - Bonds issued at a discount require the company to amortize the discount as part of interest expense over the bond's life.
    - **Journal Entry for Bond Issuance at a Discount**:
        - **Debit**: Cash (amount received)
        - **Debit**: Discount on Bonds Payable (difference between face value and issuance price)
        - **Credit**: Bonds Payable (face value)
- **Premium on Bonds**:
    - Bonds issued at a premium require amortization of the premium over the bond's life.
    - **Journal Entry for Bond Issuance at a Premium**:
        - **Debit**: Cash (amount received)
        - **Credit**: Bonds Payable (face value)
        - **Credit**: Premium on Bonds Payable (difference between issuance price and face value)

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6. Contingent Liabilities

- **Contingent Liabilities** are potential liabilities that depend on the outcome of a future event. Examples: Lawsuits, warranties, guarantees.
    - **Probable**: If the liability is probable and can be reasonably estimated, record it.
    - **Reasonably Possible**: If the liability is reasonably possible but not probable, disclose it in the notes to the financial statements.
    - **Remote**: If the liability is remote, do not recognize it or disclose it.
- **Example of Contingent Liability (Warranties)**:
    - If a company estimates it will incur warranty costs based on historical data, it will record an accrual for the estimated cost of warranties.
    - **Journal Entry**:
        - **Debit**: Warranty Expense
        - **Credit**: Warranty Liability

7. Key Terms to Know

- **Current Liabilities**
- **Accounts Payable**
- **Accrued Liabilities**
- **Unearned Revenue**
- **Short-Term Notes Payable**
- **Long-Term Liabilities**
- **Bonds Payable**
- **Premium on Bonds**
- **Discount on Bonds**
- **Contingent Liabilities**
- **Warranty Liability**
- **Pension Liabilities**
- **Interest Expense**

Practice Questions for Chapter 10: Liabilities

1. Current Liabilities: Accounts Payable

Problem 1.1: Accounts Payable
ABC Corp. receives inventory worth $5,000 from a supplier on credit. What is the journal entry to record this transaction?

2. Accrued Liabilities

Problem 2.1: Accrued Liabilities
At the end of the period, XYZ Corp. owes $2,500 in wages to employees. What is the journal entry to accrue this liability?

3. Unearned Revenue

Problem 3.1: Unearned Revenue

XYZ Corp. receives $10,000 in advance for services to be performed next month. What is the journal entry when the cash is received?

4. Short-Term Notes Payable

Problem 4.1: Short-Term Notes Payable

ABC Corp. borrows $50,000 from the bank for 6 months with an interest rate of 6%. What is the journal entry to record the borrowing?

5. Long-Term Liabilities: Bond Issuance

Problem 5.1: Bond Issuance

XYZ Corp. issues bonds with a face value of $100,000 at a 5% interest rate for 5 years. The bonds are issued at 98 (2% discount). What is the journal entry to record the issuance?

6. Bond Premium Amortization

Problem 6.1: Bond Premium Amortization

XYZ Corp. issues $100,000 in bonds at a premium of $5,000. What is the journal entry to record the amortization of the bond premium for the first year (using straight-line method)?

7. Contingent Liabilities

Problem 7.1: Contingent Liability

XYZ Corp. is involved in a lawsuit where the outcome is uncertain. If the company believes the lawsuit will likely result in a loss and estimates the loss at $50,000, what should the company do in its financial statements?

Answers to Practice Questions

Problem 1.1: Accounts Payable

- **Journal Entry**:
    - **Debit**: Inventory $5,000
    - **Credit**: Accounts Payable $5,000

Problem 2.1: Accrued Liabilities

- **Journal Entry**:
    - **Debit**: Wages Expense $2,500
    - **Credit**: Wages Payable $2,500

Problem 3.1: Unearned Revenue

- **Journal Entry**:
    - **Debit**: Cash $10,000
    - **Credit**: Unearned Revenue $10,000

Problem 4.1: Short-Term Notes Payable

- **Journal Entry**:
    - **Debit**: Cash $50,000
    - **Credit**: Notes Payable $50,000

Problem 5.1: Bond Issuance

- **Journal Entry**:
    - **Debit**: Cash $98,000
    - **Debit**: Discount on Bonds Payable $2,000

- **Credit**: Bonds Payable $100,000

Problem 6.1: Bond Premium Amortization

- **Journal Entry** (for premium amortization):
  - **Debit**: Interest Expense (amount based on bond premium)
  - **Credit**: Premium on Bonds Payable (amortized amount)

Problem 7.1: Contingent Liability

- **Action**: XYZ Corp. should record a liability for the $50,000 contingent loss if it is probable and can be reasonably estimated.
  - **Journal Entry**:
    - **Debit**: Legal Expense $50,000
    - **Credit**: Contingent Liability $50,000