

THEME: LIABILITIES

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ACCOUNTING TERM: Liability

Generally, a liability can be defined as an obligation, based on a past transaction, to convey assets or perform services in the future. Liabilities are usually categorized as “current” or “long-term”. A current liability is an amount owed that will become due within one year. A long-term liability is an amount owed that will not fall due within one year.

FEATURE ARTICLE: The Structure And Purpose Of Liabilities

Everybody knows what a liability is in one form or another. It's the mortgage we owe on our house; the outstanding balance owed on our credit cards; the debt owed to a friend who loaned us money, etc. In business, we think of liabilities in context with the balance sheet. Remember the balance sheet equation:

$$\text{Assets} = \text{Liabilities} + \text{Equity}$$

The liabilities section, as I mentioned above, is separated into two parts: current and long-term. Current liabilities are presented on the balance sheet according to a specific “ordering” criterion. You may recall that the ordering criterion for assets is based on liquidity. However, for current liabilities this is usually by “order of maturity” or according to “amount” (largest to smallest). It is difficult to satisfy both objectives, and the usual compromise is to rank current liabilities in order of size unless differences in maturity dates are significant.

An example would be that if you had a cash overdraft that would be satisfied within the month, or a promissory note that would be satisfied shortly after the balance sheet date, those items would be listed first.

The reality of it is that once the chart of accounts is established it isn't practical to change the current liability general ledger accounts each time a balance becomes larger than the other. In fact, I never use a “Cash Deficit” account when cash has a negative balance. I simply let the cash account show negative with brackets around the number. Keep in mind that I am referring to financial statements that are not using Generally Accepted Accounting Principles (GAAP).

The following is a sample of the typical ordering of current liabilities for a small business financial statement:

Bank Line of Credit
Accounts Payable

Credit Card Payable
 Payroll Taxes Payable
 Employee FIT & FICA
 Employee SIT & SDI
 Employer Payroll Taxes FICA, FUTA, SUTA
 Accrued Salaries & Wages
 Sales Tax Payable
 Deferred Income
 Federal & State Income Tax Payable
 Pension Contribution Payable
 Notes Payable (-1yr)
 Due to Stockholder or Partner (-1 yr)
 Current Portion of Long-Term Debt

As you probably know, an increase to a liability account is recorded on the credit (right) side of the ledger and a decrease is recorded on the debit (left) side the ledger. Let's look at some examples:

(1) If \$500 is borrowed from the bank using a line of credit account the journal entry would be:

DESCRIPTION	DEBIT	CREDIT
Cash	500	
Line of Credit		500

If \$100 was paid on the balance the journal entry would be:

DESCRIPTION	DEBIT	CREDIT
Line of Credit	100	
Cash		100

(2) A purchase of Inventory on account for \$5000:

DESCRIPTION	DEBIT	CREDIT
Inventory	5,000	
Accounts Payable		5,000

If \$1,000 was paid on account:

DESCRIPTION	DEBIT	CREDIT
Accounts Payable	1,000	
Cash		1,000

(3) A charge on the credit card of \$1,800:

DESCRIPTION	DEBIT	CREDIT
Office Supplies	800	
Travel	1,000	
CC Payable		1,800

A payment of \$200 was made on the card:

DESCRIPTION	DEBIT	CREDIT
CC Payable	200	
Cash		200

I think you get the drift so let's turn our attention to long-term liabilities. Usually these consist of formal interest-bearing agreements that have a maturity of more than one year. Some examples are:

Notes Payable
Lease Obligation (capital lease)
Due to Partner or Stockholder (+1 yr)
Current Portion of Long-term debt

When money is borrowed a note is set up with a journal entry:

DESCRIPTION	DEBIT	CREDIT
Cash	10,000	
Notes Payable		10,000

When a payment is made the principal portion of the note plus interest has to be accounted for:

DESCRIPTION	DEBIT	CREDIT
Notes Payable	500	
Interest Expense	133	
Cash		633

A lease obligation is recorded the same as a note payable.

Keeping track of the liabilities of a business is extremely important. When the liabilities are weighed against the company's assets the health of the business becomes clear.

QUESTION: What Part Do Liabilities Play In Determining Working Capital?

First, let's review what "working capital" is. It is defined as the excess of current assets over current liabilities in a business enterprise. This makes sense because after the obligation to pay the current liabilities has been met, the remaining assets (usually cash or its equivalent) can be used to finance current operations.

The part that is tricky is determining which current assets and liabilities to include and exclude in the measure. The idea is that there needs to be enough current assets to pay for the liabilities that were initially incurred to facilitate the operating cycle of the business. An operating cycle is usually considered to be one year. However, a business may have a longer or shorter actual business cycle. In either regard, if a current asset, such as cash, has been set aside to purchase plant fixed assets that have a useful life of seven years, then those funds clearly should not be considered current. This is just one example of the kind of consideration that is necessary when determining working capital.

Another area of confusion I often hear about is the use of the general ledger account "Current Portion of Long-term Debt". Part of current liabilities is the principal portion of the long-term notes payable that will be paid during a one year period (or operating cycle). The "current portion" account is used to remove that amount from the long-term liabilities and add it to the current liabilities. For example, let's say that you had three long-term notes payables. After running an amortization schedule for each one it was determined that the principal reduction in one year totaled \$5,000. To move this amount to the current liabilities section requires a journal entry like this:

DESCRIPTION	DEBIT	CREDIT
Current Portion L/T Debt	5,000	
Current Port L/T Debt		5,000

The debit decreases the long-term debt and the credit increases the current liabilities. Now the liability section of the balance sheet is more accurately represented. Although the accounts have the same name, their general ledger numbers will be different. Keep in mind, that unless you have a need for this level of precision, it may not be worth the bother.

Working capital is an easy measure of the short-term solvency of a company. The relationship between current assets and current liabilities is called the "current ratio". It is used frequently by creditors to decide risk in granting a business credit. Therefore, if a third party is assessing the health of your company, make sure your assets and liabilities are relevant to each other. In other words, compare apples to apples.

TIP: Using “Due To” and “Due From” Accounts.

Sometimes a stockholder or a partner loans money to the business or takes a temporary draw with the intent of paying it back in short order. This is a common occurrence in small businesses so a vehicle is needed to handle such events.

Here is an example of a situation that just occurred for a client of mine. A new 50/50 partnership was formed but the partners did not contribute an equal amount of capital. They were off by about \$1,000. Instead of having the capital accounts uneven and preparing a tax return that way, I felt it was much easier and cleaner to make the capital accounts even and reclassify the difference to a Due to Partner liability account. During the next year, the other partner can make up the difference and then I will reclassify the Due to Partner account to that partner’s capital account. Or, when funds become available the partner with the excess can be reimbursed and the Due to Partner account will be cleared.

Another scenario is when a partner or stockholder needs some ready cash and borrows from the business. In this instance, I would set up a Due from Partner in the asset section near Accounts Receivable. Usually, in these circumstances no interest is charged or paid. However, under audit in the U.S., the Internal Revenue Service (IRS) may impute the interest since they don’t believe there is such a thing as an interest free loan. A rule of thumb that may or may not be true is that they don’t pay attention to anything under \$10,000. Regardless, it is a device that can be used to accommodate these kinds of circumstances.

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