Accounting for Liabilities.

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ACCOUNTING FOR LIABILITIES

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by

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ABSTRACT

This work deals with liability accounting, only one of many areas of accounting in which improvement is necessary. The improvement of liability accounting involves solutions to the problems of defining, measuring, and classifying liabilities. It is the purpose of this work to present a theory of liability accounting which will enable the accountant to solve these problems.

After a careful examination of various definitions of the term "liability," it is concluded that these definitions lack satisfactory criteria for determining if an item is a liability. However, an analysis of these definitions indicate that a liability has the following characteristics: (1) it is an obligation; (2) it requires a future outlay of money or its equivalent; (3) it is the result of a past or current transaction; and (4) its amount is subject to reliable estimation.

These characteristics are used as criteria to determine if selected items qualify as liabilities. Deferred income taxes, unearned interest income, deferred gross profit on installment sales, estimated future collection costs on receivables, reserve for repairs, and reserve for self-insurance are items which do not qualify as liabilities according to the above characteristics. Warranties and guarantees, long-term leases, and pensions are liabilities since they have all
the characteristics of liabilities.

Most accountants measure a liability at its face value. The effective amount of a liability, however, is not the face value; it is the present value of all future payments. Since the interest factor is usually not significant in the case of current liabilities, it can be ignored (except in a case where a short-term obligation explicitly recognizes an element of interest) in measuring these liabilities. Long-term liabilities should be measured by the present value of all future payments. The yield interest rate at date of issue should be used in determining the amount of the liability. This procedure is sound since it is consistent with the cost basis of measuring assets.

It is common accounting practice to record interest bearing obligations at their face value. However, these obligations should be recorded by crediting a liability account for the proceeds received from the issuance of such obligations. Accrued interest (computed at the yield rate) is also credited to this same liability account. The above procedure results in the presentation of both liabilities (the liability for interest and the liability for the proceeds) in the same account. In addition, this procedure also eliminates the need for discount and premium accounts.

There are two concepts of the classification of the credit side of the balance sheet: the entity concept and the proprietary concept.
After a careful evaluation of these two concepts, it is concluded that the entity concept is more applicable to the modern business enterprise. Thus, the entity concept is adopted in this work.

The present practice of separating liabilities into current and long-term groups should be retained since it plays a very important role in financial statement analysis. The following concept of liability classification is employed in this work: a current liability is one which will be paid within the operating cycle and which will require for its liquidation the use of current assets or the creation of other current liabilities. Any liability not meeting these requirements is classified as long-term.

The final portion of this work is devoted to an analysis of accounting for contingent liabilities. From this analysis it is concluded that contingent liabilities of a material amount should be disclosed in the financial statements by the use of footnotes.
CHAPTER I

INTRODUCTION

One of the objectives of accounting is to report the financial condition of the business enterprise through the use of the balance sheet and the income statement. In recent years accountants have emphasized the importance of the income statement in the reporting of financial data. This preoccupation of accountants with income measurement has had the effect of downgrading the importance of the balance sheet in financial reporting.

To some accountants the balance sheet is a "static analysis with little purpose other than to assure the reader that equilibrium is still maintained." If this is true, it is time for accountants to consider what might be done to improve the balance sheet.

Many accounting writers have made suggestions for the improvement of the form of the balance sheet. Although form is important, it is the content of the statement which is of utmost importance to the reader. An analysis of the financial condition of a firm must be based on data contained in the financial report. If the balance sheet is to

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regain its lost stature, then improvements must be made so that this statement will accurately reflect the financial condition of the business enterprise.

There are many areas in which improvements need to be made in the balance sheet; however, this dissertation is limited to only one of these areas—liabilities. Improvements in the reporting of liabilities are important for two reasons:

1. The inaccurate reporting of liabilities can affect the balance sheet assets and/or the reported income. For example, the omission of an account payable from the balance sheet can result in an understatement of inventory, or the failure to recognize certain accrued liabilities can result in the overstatement of net income. Furthermore, the failure to record a liability can distort both the balance sheet and the income statement. This is true where the debit part of the transaction involves a cost which must be apportioned between an asset account and an expense account.

2. The omission of certain liabilities from the balance sheet can lead to misleading conclusions concerning the financial solvency of a business enterprise. For example, the omission of a long-term lease from the
balance sheet can seriously jeopardize a reader's judgment of the financial soundness of a company.

Most accountants realize the importance of improving present-day liability accounting practice. There has been a great deal of writing on this subject by authoritative accounting writers; however, these writings are too often concerned with the technical aspects of liability accounting, such as auditing programs and internal control. Improvements in these areas are certainly needed, but there is also a need for the development of a sound theory of liability accounting. Such a theory would form the basic foundation for further improvements in auditing and controlling liabilities. One of the objectives of this study is to develop a theory of liability accounting, and then to apply this theory to some of the current problems of accounting for liabilities.

Problems of Accounting for Liabilities

In recent years accountants have been overly concerned with the correct matching of costs and revenues. The zealous pursuit of this objective has resulted in the creation of certain accounts with credit balances which appear in the balance sheet as liabilities. These credit items have been the source of a great deal of controversy among accountants; such controversies seem to indicate a lack of understanding of the concept of liabilities. This is primarily a problem of the proper definition of the term "liability."
In addition to the problem of definition, there is also the problem of the measurement of liabilities. This has plagued accountants for many years, and is a result of the lack of clear-cut accounting principles of liability measurement. The accountant, then, needs a set of principles which will enable him to correctly measure liabilities for balance sheet purposes.

Another problem which should be mentioned at this time involves the classification of liabilities. This is a problem which embraces the entire credit side of the balance sheet. There are two theories on this subject: the entity theory and the proprietary theory. The advocates of the entity theory would prefer that both liability and ownership accounts be classified as equities; the advocates of the proprietary theory would prefer to retain the present division of the credit side of the balance sheet into liability and ownership sections.

There is also the problem of classifying liabilities into various groups. Traditionally, liabilities have been classified as either current liabilities or long-term liabilities, usually based on the one-year rule; that is, liabilities maturing within one year from balance sheet date are classified as current liabilities while liabilities maturing after one year from balance sheet date are classified as long-term liabilities. There has been a great deal of criticism of the one-year rule, which perhaps indicates that the time has come for a new basis
for classifying liabilities.

The problems of defining, measuring, and classifying liabilities are problems the accountant faces every day. As pointed out earlier, there is a considerable amount of controversy among accountants as to how these problems should be solved. The purpose of this dissertation is to point out some of the theories and analyses of accounting authorities regarding these problems, and to synthesize the theories and arguments wherever possible. The solution to the problems of defining, measuring, and classifying liabilities is necessary for a sound theory of liability accounting.

Scope and Limitations of the Study

The topic "Accounting for Liabilities" is very broad in scope, and many dissertations could be written concerning component parts of this topic. For this reason, then, it is necessary to limit the scope of this study to the theoretical nature of liability accounting. In the process of developing such a theory, it will be necessary to survey many topics and to dwell more thoroughly on those concepts which are more important or which give rise to divergent theories among accounting writers.

Since this study is concerned with theory, no attempt will be made to discuss auditing, internal control, or managerial problems of liability accounting. The auditing of liabilities has been thoroughly
covered in the many fine auditing textbooks. Internal control of liabilities has also received a great deal of attention in auditing textbooks as well as in textbooks on controllership and internal auditing. The problem of the management of liabilities is covered in corporation finance and managerial accounting textbooks.

Organization of this Study

The nature of liability accounting will be described in Chapter II. This description involves the formulation of a basic definition of liabilities which can be used to determine which items may be included in the balance sheet as liabilities. Furthermore, the problem of correctly measuring liabilities will also be discussed at this time. The principles developed in this chapter will be used to define and measure specific liabilities in later chapters.

The purpose of Chapter III is to describe briefly the general nature of the entity and proprietary concepts of the credit side of the balance sheet. The remainder of the chapter is devoted to criticism of these two concepts.

Chapter IV is concerned with the classification of liabilities into various groups. The traditional methods of liability classification are described and evaluated. It is also the objective of this chapter to develop a new concept of liability classification.

The problem of accounting for current liabilities will be covered
in Chapter V. Each current liability item will be examined to see if it meets the requirements for a liability as set forth in Chapter II, and the methods for measuring the liability will be carefully evaluated. The same procedures will be employed for long-term liabilities in Chapter VI.

The purpose of Chapter VII is to define contingent liabilities, show how they are to be presented in the balance sheet, and to describe briefly some of the common types of contingent liabilities.

In Chapter VIII the conclusions and recommendations in the preceding chapters dealing with current, long-term, and contingent liabilities will be summarized. In addition, several conclusions with regard to the general nature of liabilities will be presented.
CHAPTER II

NATURE OF LIABILITIES

What is a liability? How is it to be measured? These are questions the accountant must be able to answer if he is to accurately define and measure liabilities for accounting purposes. The accounting definition of liabilities of a few years ago is no longer sufficient to cope with the increasing complexities of corporate accounting. In addition, improvements in the principles of liability measurement are needed so that the accountant can assign the correct dollar amount to liabilities. The purpose of this chapter is to develop an accounting definition of liabilities along with certain principles of liability measurement.

Definition of Liabilities

Many attempts have been made by accounting writers and organizations to define the term "liability." These definitions generally have been unable to provide satisfactory criteria for determining whether or not a credit item is a liability. Furthermore, there is no agreement among accountants as to what constitutes a liability. Maurice Moonitz lists three reasons for this lack of agreement:
1. Based upon experience, accountants for the most part assume "normal" developments in the future in assessing the presence and magnitude of debts. For example, accountants assume ordinarily that contracts entered into will be honored by the participants, as in fact they are in most cases. Breach of contract is not contemplated as normal or usual. The "allowance for bad debts" measures our estimate of the extent to which this assumption is inaccurate.

2. Lawyers, in the nature of their profession, must be concerned with what happens if participants do not live up to their agreements, or what amounts to the same thing, analytically, disagree as to the meanings of the contracts made. As a consequence, the law (to the extent that it is influenced by this attitude) tends to recognize debts only when a rather rigorous set of conditions has been satisfied.

3. The income tax is influenced greatly by both law and accounting but, in addition, must recognize the demand of administration. For example, certainty and accuracy of income and deductions may be more important than the equity of the results. Also, income tax rules and regulations must always be influenced by the Treasury's interest in protection of revenue.¹

The accounting definition of liability is usually patterned after the legal definition. Therefore, it is necessary to give the legal definition before further discussion.

Legal definition of liability. The word "liability" has a number of different meanings. Oliver Wendell Holmes once said that "a word is not a crystal, transparent and unchanged; it is the skin of the

living thought and may vary greatly in color and content according to the circumstances and the time in which it is used."² This statement accurately describes the word "liability" when it is used in legal language. The different shades of meaning are reflected in the following legal definition:

The term (liability) has been variously defined as meaning amenability or responsibility to law; responsibility; legal responsibility; obligation; that condition of affairs which gives rise to an obligation to do a particular thing to be enforced by action; the condition of being actually or potentially subject to an obligation; the condition of being responsible for a possible or actual loss, penalty, evil, expense, or burden; the condition of one who is subject to a charge or duty which may be judicially enforced; the state of one who is bound in law and justice to do something which may be enforced by action; the state or condition of one who is under obligation to do at once or at some future time something which may be enforced by action. It is a condition which creates a duty to perform an act.

In a restricted sense, liability is that which one is under obligation to pay to another, that for which one is responsible or liable; that which one is under obligation to pay, or for which one is liable; one's pecuniary obligations, or debts collectively.³

The first paragraph of this legal definition is very broad and covers a wide range of meanings. The second paragraph is usually what one has in mind when he thinks of the legal definition of a liability. This latter definition can be made even more restrictive by


considering the legal definition of "debt," which Black's Law Dictionary defines as:

A sum of money due by certain and express agreement; as by bonds for a determined sum, a bill or note, a special bargain, or a rent reserved on a lease where the amount is fixed and specific, and does not depend upon any subsequent valuation to settle.  

The legal definitions of liability and debt are insufficient for accounting purposes. For example, real estate taxes are said in law to become a liability on the lien date; that is, the day on which they become a lien on the property. The accountant normally spreads this tax ratably over a period of time, and he might begin to reflect the liability a year in advance of the lien date. Other examples can be cited to show the limitation of the legal definition, thus indicating the need for a broader definition for the purposes of accounting.

Accounting definition of liability. Most accounting definitions of liability seem to indicate a lack of understanding of the very concept. Perhaps this is because accountants have not given enough thought to the accounting implications of such a definition. A review of some of the definitions currently in use will help clarify this statement.


Accounting Terminology Bulletins, Review and Resume gives the following definition of liability:

Similarly, in relation to an asset, liability may be defined as follows:

"Something represented by a credit balance that is or would be properly carried forward upon a closing of books of accounting according to the rules of principles of accounting, provided such credit balance is not in effect a negative balance applicable to an asset. Thus, the word is used broadly to comprise not only items which constitute liabilities in the popular sense of debts or obligations (including provisions for those that are unascertained), but also credit balances to be accounted for which do not involve the debtor and creditor relation. For example, capital stock and related or similar elements of proprietorship are balance sheet liabilities in that they represent balances to be accounted for, though these are not liabilities in the ordinary sense of debts owed to legal creditors."

Consideration of the facts noted in the last sentence of this definition has led some accountants to view that the aggregate of liabilities as contemplated in this definition should be referred to as the aggregate of liabilities and capital, and that the balance sheet consists of an asset section, a liability section, and a proprietary or capital section, with the monetary amounts represented by the first shown as equal to the sum of those represented by the other two. The committee feels that there is not inconsistency between this view and the suggested definition.6

This definition is almost completely useless in determining if an item should be designated a liability. In fact, one accounting writer made the following comment:

This definition (Accounting Terminology Bulletins' definition of liabilities) says in effect that if you want to know what a liability is, ask an accountant. But I am an accountant and you are an accountant. Whom do we ask? 7

Another popular source of accounting definitions is Kohler's A Dictionary for Accountants, in which "liability" is defined as:

1. An amount owing by one person (a debtor) to another person (a creditor), payable in money, or in goods or services: the consequence of an asset or service received or a loss incurred; particularly, any debt (a) due or past due (current liability), (b) due at a specified time in the future (e.g., funded debt, accrued liability), or (c) due only on failure to perform a future act (deferred income; contingent liability). 8

Kohler's definition is patterned after the legal definition. He stresses the debtor-creditor relationship as a means of determining if a liability exists. As pointed out earlier, definitions based on legal tests are unsuitable for accounting purposes.

The Committee on Concepts and Standards of the American Accounting Association, in its 1957 revision, gives the following definition of liabilities:

7Moonitz, op. cit., p. 43.

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The Committee on Concepts and Standards of the American Accounting Association, in its 1957 revision, gives the following definition of liabilities:

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7Moonitz, op. cit., p. 43.

The interests or equities of creditors (liabilities) are claims against the entity arising from past activities or events which, in the usual case, require for their satisfaction the expenditure of corporate resources.\footnote{American Accounting Association, Committee on Concepts and Standards, Accounting and Reporting Standards for Corporate Financial Statements and Preceding Statements and Supplements (Columbus, Ohio: American Accounting Association, 1957), p. 7.}

This definition, like Komier's, emphasizes the debtor-creditor relationship. Apparently the Committee feels that the legal aspects of liabilities are very important because the determination of both the debtor and creditor is strictly a legal matter.

The definitions presented thus far have been based on the legal concept of liabilities. However, one writer, William J. Vatter,\footnote{William J. Vatter, The Fund Theory of Accounting and Its Implications for Financial Reports (Chicago: The University of Chicago Press, 1947), p. 95.} gives an "accounting" rather than a "legal" definition:

As distinct from the notion of obligation or legal liability, equities are restrictions upon, or reservations that apply to the assets of the fund; they may arise from legal, equitable, economic, or even managerial considerations. Although some equities are removed by the process of disbursement, they may be discharged or they may disappear for a considerable number of reasons. Their relations to assets are rather indirect; rarely is there a specific pattern of relationships between assets and equities, except that the total of equities must be equal to the total of assets, because of the residual restrictions embodied in the definition of the fund itself.
An "accounting" definition like its "legal" counterpart has its faults. For one thing, accountants cannot ignore the legal aspects in the determination of a liability. The omission of a legal liability from the balance sheet just because it does not qualify under the "accounting" definition would result in a misrepresentation of the financial position of the company. The legal concept of a liability must be a part of the definition; however, for a definition to be useful, it must contain both the legal and accounting concepts. Furthermore, an ideal definition of a liability should be able, by its use, to tell (a) whether all items labeled as "liabilities" in the balance sheet really deserve the label; (b) which of two or more alternative practices with respect to a liability is correct; and (c) whether financial events disclosed in footnotes or elsewhere should be reflected in the balance sheet itself. Moreover, a definition should enable an accountant to analyze new situations as they arise to determine if a liability is present.

Sprouse and Moonitz, in a recent research study for the American Institute of Certified Public Accountants, have included, to a certain extent, both the legal and accounting concepts in their definition:

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Moonitz, op. cit., p. 44.
The liabilities of a business enterprise are its obligations to convey assets or perform services, obligations resulting from past or current transactions and requiring settlement in the future. The term "obligation" connotes a claim or series of claims against the business enterprise, each of which has a known or reasonably determinable maturity date and an independent value which is known or reasonably measurable. Settlement of a specific obligation may involve payment in cash or in other assets, or the performance of service. Ultimate settlement may be postponed by the substitution of another obligation. At the option of the obligee (the creditor), the liability may on occasion be settled by conversion into ownership interest. Neither the maturity date nor the value of the obligation needs to be known precisely for the obligation to constitute a liability of the enterprise. Further, the specific party with whom ultimate settlement must be made need not be immediately identifiable. For example, warranties are liabilities which may require settlement within a time period which must be estimated, in an amount which cannot be estimated with complete accuracy, and to persons who are not known at the time the warranty creates an obligation.

This definition is useful for accounting purposes. No attempt will be made to improve on Sprouse and Moonitz's definition; however, there is one approach to the problem of defining liabilities that most accountants have overlooked--the characteristics of a liability. A liability exhibits certain characteristics and these can be used as a basis for developing criteria in determining whether an item is a liability. These characteristics will be thoroughly discussed in the next section.

Characteristics of A Liability

After a careful analysis of all the preceding definitions, the following four characteristics of a liability were obtained: (1) a liability is an obligation; (2) a liability involves a future outlay of money or its equivalent; (3) a liability is a result of past or current transactions; and (4) the amount of the liability must be known or reasonably estimated.

A liability is an obligation. Webster defines "obligation" as "That which a person is bound to do or follow, any duty imposed by law, promise, or contract, by the relations of society or by courtesy, kindness, etc." 13

The term "obligation," as used in accounting, connotes a duty to deliver assets or perform services for someone outside of the business enterprise. It also implies that there are claims or a series of claims against the business enterprise which require settlement in the future. 14 In addition, the term "obligation" includes all legal "debts" as well as claims which are not yet legal "debts" but still require a future outlay of cash or its equivalent.

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14Sprouse and Moonitz, op. cit., p. 37.
A liability involves a future outlay of money or its equivalent. For an item to be classified as a liability, it must require a future outlay of money or its equivalent. The settlement of a specific liability may require a future outlay of assets or performance of service. This future outlay may be postponed by the substitution of another obligation.\(^{15}\) In addition, a liability may be settled by conversion into ownership interest.

A liability is the result of past or current transactions. Paton defines a transaction as "any occurrence, process, condition, or decision which brings about a change in the financial status of the enterprise..."\(^{16}\) In addition, it might be added that a transaction involves a relationship between the business enterprise and some outside person or entity; that is, it involves an "external" business event.

The different types of business transactions may be identified in the following way:

1. Purchase of various services, most of which are consumed or used up in the course of business operations. These include services of persons, and of things such as merchandise, materials and supplies, buildings, machinery, and other equipment.

\(^{15}\)Ibid.

2. Sales of commodities (the stock in trade), including personal service, varying with the nature of business operations.

3. Issuance and receipt or acquisition of payables and receivables, and of written promises such as notes, bonds, and other forms of contractual instruments.

4. Cash receipts and disbursements. ¹⁷

These types of transactions include liabilities arising from financial events which take place between two distinct accounting entities. All types of accruals (including accrued liabilities) are excluded since they are not "external" transactions. However, accruals can easily be accounted for since they usually are a result of external transactions. Accruals represent either consequences of changes in values connected with the continuation through time of contractual relations previously undertaken with outsiders, or changes in value with which outsiders are not directly concerned. ¹⁸ The different types of accruals may result from:

1. The reflection in the records of the effect of contract terms. For example, in transactions involving financial instruments (notes, bonds, mortgages, etc.) the accruing of interest, including the amortization of discount and premium, etc.


¹⁸ Ibid., p. 56.
2. The reflection of obligations imposed by law, as for example the accruing of property taxes, of social security and other payroll levies, of sales and excise taxes, and the estimation of taxes on income. The proper classification of taxes is admittedly difficult, not only in accounting but in the related fields of corporate finance and economic analysis. Dependent on one's social attitudes, a tax may be viewed for example as the result of an "implied contract" between government and taxpayer, or as a forced levy on unwilling subjects. Most of us would probably take position somewhere between these two extremes.

3. The reflection of expiration of values, as for example depreciation of other amortization or assets, and the recognition of cost of goods sold to customers. Here may be included the consumption of valuable services evidenced by the conversion into finished goods of materials, labor and "indirect" production costs. The latter group reflects the process of transformation of assets in the basic meaning of the term. ¹⁹

The expression "past or current transactions" encompasses liabilities arising from financial events with persons or entities outside of the business enterprise as well as accrued liabilities. Events which have not yet occurred are excluded because they do not qualify under this third characteristic. Thus, such items as next year's bond issue, next month's raw materials purchases, or next year's fixed asset purchases cannot be considered as liabilities since they are future events.

¹⁹Ibid.
The amount of the liability must be known or reasonably estimated. In order for a transaction to be recorded, the amounts to be debited and credited must be known. This is one of the basic concepts of accounting. Paton and Littleton have an excellent presentation of this concept in their Introduction to Corporate Accounting Standards.

The activities of the specific business enterprise, with respect to which the accountant must apply pertinent information, consists largely of exchange transactions with other enterprises. Accounting undertakes to express these exchanges quantitatively. The basic subject matter of accounting is therefore the measured consideration involved in exchange activities, especially those which are related to service acquired (cost, expense) and services rendered (revenue, income).20

If this statement is applied to a liability, then it is apparent that the amount of the liability must be known or reasonably measurable before it can be recorded. However, this does not mean that a liability whose exact amount is not known should be excluded from the financial statements. The accountant, in such cases, should estimate with as much accuracy as possible the amount of the liability. For example, service guarantees are liabilities whose amounts must be estimated at the time the guarantee creates an obligation.

The characteristics described in this chapter will be used as

criteria for determining if a credit item can qualify as a liability. Each credit item will be carefully examined to find out if it: (1) is an obligation; (2) requires a future outlay of money or its equivalent; (3) is a result of a past or current transaction; and (4) is subject to reliable estimation. If the credit item does not meet these requirements, then it is not a liability.

Measurement of Liabilities

Accountants generally measure a liability at its face or maturity value. This procedure is the result of the accountant's lack of concern for the time element and its effect on the amount of the liability to be shown in the financial statements. A business enterprise views a dollar to be paid tomorrow as being much more significant than a dollar to be paid ten years from now. In other words, the effective amount of a liability is the discounted value of the future cash outlay or series of cash outlays. Therefore, a liability, for accounting purposes, should be measured by the discounted value of all future cash payments.

A liability may require a future outlay of goods or performance of service rather than settlement by a cash payment. Liabilities of this type are usually the result of deposits or other advances from customers for the future delivery of goods or the performance of service. These liabilities should be measured by the amount of
the deposit or advance which is usually equal to the agreed-upon exchange price of these commodities. The amount received from the customer is the present value of the liability; that is, there is an interest element inherent in an advance from a customer and this element arises because the value of the services to be rendered to the customer is greater than the value of the advance payment.

For discussion purposes, liabilities will be separated into two groups: short-term and long-term liabilities. Short-term liabilities are those which will be paid in a relatively short period of time, such as ordinary accounts payable and notes payable. Long-term liabilities consist of such items as bonds, mortgages, long-term notes, etc. The segregation of liabilities into short-term and long-term categories is merely for the discussion of the measurement of liabilities and has nothing whatsoever to do with the classification of liabilities.

Measurement of short-term liabilities. John B. Canning was one of the first accounting writers to recognize the element of interest in the measurement of short-term obligations. He advocates the

21 Sprouse and Moonitz, op. cit., p. 41.

presentation of short-term liabilities in the balance sheet at their present worth rather than the future amount to be paid. In addition, he prefers to deduct the cash discount from trade accounts payable to arrive at the effective amount of the liability for balance sheet purposes.

There are many accountants who would agree with Canning on measuring accounts payable net of cash discounts, but few would go so far as to measure other short-term obligations at their present worth. Sprouse and Moonitz would recognize the interest factor in the case where short-term obligations explicitly recognize the element of interest; however, where short-term obligations do not explicitly recognize the element of interest, the interest factor should be ignored since the force of interest is ordinarily negligible due to the short span between the future payment and the present measurement. Although this statement may be criticized as being inconsistent with the measurement of other liabilities at their present value, it would be expedient from a practical standpoint, to go along with Sprouse and Moonitz. This does not preclude the measurement of accounts payable net of cash discounts or other short-term liabilities at the lowest amount at which they could be effectively discharged.²⁴

²³Sprouse and Moonitz, op. cit., p. 39.

²⁴Ibid.
Measurement of long-term liabilities. Long-term liabilities should be measured by the present or discounted value of all future payments. These future payments include the amount due at maturity, whether in a lump-sum or in installments, and, in addition, all future interest payments. The yield or effective rate of interest at date of issue should be used for computing the present value of the long-term liability.

The inclusion of interest payments in measuring long-term liabilities is not the usual procedure followed by most accountants. These accountants fail to recognize, for example, that all bond transactions involve two liabilities rather than one. There is a promise to pay a certain amount at maturity date, and there is the separate promise to pay interest on the first amount on designated interest dates. The promise to pay interest is really a promise to pay a series of sums certain. Thus the total amount of the liability is the discounted value of the maturity or face value of the bond and the future interest payments. If the yield or effective rate of interest is equal to the contract rate, then the discounted value of the two liabilities (maturity value and interest payments) will total the maturity value of the bond. However, where the yield rate of interest

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differs from the contract rate, then the total amount of the liability is equal to the proceeds of the bond issue at date of issue.

The use of the yield or effective rate of interest at date of issue is sound, in that it is related to the method for measuring assets. For example, if assets are measured at current value, then liabilities should also be measured in the same way. For example, if bonds are actively traded on the open market, then the current market value of these bonds should be reflected in the balance sheet. Since the market value of bonds is a direct result of the current market interest rate, then each time this rate changes there would be a change in the recorded value of the bond liability. The change in interest rates could also be brought about by a change in the financial standing of the business enterprise.

The use of the yield rate of interest at date of issue is consistent with the cost basis for measuring assets. The discounted value of the future payments can be thought of as the "cost" of the liability. Furthermore, depreciation expense based on the original cost of a fixed asset is analogous to interest expense based on the yield rate of interest at date of issue. In addition, if depreciation is based on current value of the asset, then interest expense should be based on the current market interest rate.

The main reason, then, for using the yield rate of interest
at date of issue is that it is consistent with the cost basis for measuring assets. The use of the cost basis for measuring assets is widely accepted in both theory and practice. For this reason, the use of current values for measuring assets and liabilities will not be covered in this study. However, the principles of liability measurement based on the yield rate of interest can be easily adapted to the measurement of liabilities at current values.

Summary

Many attempts have been made by accounting writers and organizations to define the term "liability." The definitions, for the most part, have failed to provide satisfactory criteria for determining if a credit item is a liability. A liability, however, exhibits certain characteristics which can be used as criteria for purposes of defining liabilities. These characteristics are: (1) an obligation; (2) a future outlay of money or its equivalent; (3) a result of a past or current transaction; and (4) subject to close estimation.

A liability, for accounting purposes, should be measured by the discounted value of all future cash payments. Liabilities which require a future outlay of goods or performance of service should be measured by the agreed upon exchange price of these commodities. Short-term liabilities should recognize the element of interest in the
case where short-term obligation explicitly recognizes the element of interest, but otherwise the interest factor should be ignored. Both the maturity value and future interest payments should be included in determining the present value of a long-term liability. The yield or effective rate of interest at date of issue should be used in arriving at the discounted value of the liability.
CHAPTER III

ENTITY AND PROPRIETARY CONCEPTS OF LIABILITY

There are two widely-held concepts regarding the credit side of the balance sheet: the proprietary concept and the entity concept. The proprietary concept, the oldest of the two, had its beginning in the earlier part of the nineteenth century. It was the speculation of the writers of this period concerning the fundamental nature of double-entry bookkeeping that led to the concept of the proprietary equity. Also the nineteenth century saw bookkeeping expand into accounting, and there emerged a theory of accounting based upon the proprietary concept.

The advent of the large corporation caused many accountants to feel that the proprietary concept was inadequate because it could not meet the new problems evoked by the corporate form of business

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1The proprietary concept is sometimes referred to as the "representative" or "agency" concept. Also, the term "management" or "managerial entity" is often substituted for the term "entity." The terms "proprietary" and "entity" will be employed in this work.


3Ibid., p. 166.

4Ibid., p. 165.
enterprise.\textsuperscript{5} In an attempt to solve these problems, the entity concept was formulated,\textsuperscript{6} which today is an integral part of modern accounting theory.

Since the proprietary and entity concepts embrace all areas of accounting, it is necessary to limit the scope of this chapter to a discussion of their application to the balance sheet presentation of liabilities and proprietorship.

Entity Concept of Liabilities

The holders of the entity concept maintain that liabilities and proprietorship are not separate and distinct, but are interdependent parts of a larger class, equities. Thus, for balance sheet purposes, both liabilities and proprietorship are shown under the general heading of "equities." The accounting equation, assets equal liabilities plus proprietorship, reflects the entity concept. Still better, perhaps, the equation might be stated as assets equal equities.

There are many accounting writers who favor the term "equities" as a title for the right-hand side of the balance sheet. William A. Paton, one of the leading advocates of the entity concept, states that "the classes, proprietorship and liabilities, are actually


\textsuperscript{6}Ibid., p. 365.
sections of a larger division, and that the equation, properties equal equities, is the most logical expression of the financial condition of the business enterprise. 7 Mortimer Daniels seems to be in accord with Paton when he says, "The total fund thought of from the standpoint of the legal claims therein, or of the source from which obtained, is the accounting concept of equities, or liabilities plus proprietorship (capital stock and surplus.)" 8 Kenneth MacNeal, another proponent of the entity concept, says, "The function of the liability side of the balance sheet should be to exhibit the equities of the different parties in the total wealth of a business, as shown by the asset side of the balance sheet." 9 Although these statements were made in the first half of this century, they still reflect the viewpoint of many present-day accountants.

The arguments advanced by the proponents of the entity concept fall into three categories: (1) similarities between stockholders and creditors, (2) similarities between stocks and bonds, and (3) the corporation as a separate entity. In the discussion which follows, 


the business enterprise is assumed to be a large corporation; however, as many authors point out, the entity concept can be applied to any business organization, whether it be sole proprietorship, partnership, or corporation.

**Similarities between stockholders and creditors.** The holders of the entity concept contend that in some cases the stockholder is similar to a creditor and that in other cases the creditor is similar to a stockholder. There are several reasons why this may be true.

First, the stockholders of a corporation may act more like creditors than owners. Erwin Boehmler points this out when he says:

In effect, the great mass of stockholders conduct themselves more nearly like creditors, than owners. In fact, this is but a manifestation of the separation of ownership and control (management) that has so frequently been noted as characteristic of our time. For this reason some writers have called stocks "investment credit instruments." ¹⁰

One of the reasons for this state of affairs has been the lack of interest on the part of most stockholders in the operation of the business. A great majority of stockholders are interested in only this year's dividend or the current market price of their stock. Although the members of the corporate society may be charged by law with the

Theoretical responsibility of ownership, the practical situation is that very few stockholders carry out their responsibility. Thus, the stockholder's indifference, inertia, and inarticulateness have made him more in the nature of a creditor than an owner.

Second, a bond is a contract between the corporation and the bondholder while a share of stock is a contract between the corporation and shareholder. Stated differently, and viewed from the bondholder or shareholder's standpoint, the imparting of capital results in a claim against the assets of the corporation. This position is supported by Paton and A. C. Littleton who say that "those who contribute capital have a claim against the assets according to their contracts." However, the claims are against the corporate whole and not against specific assets since the corporation holds title to all assets. This statement is correct as long as the corporation continues to do business, for at any time the corporation is liquidated there will be certain creditors with claims against specific


13 W. A. Paton and A. C. Littleton, An Introduction to Corporate Accounting Standards (Columbus, Ohio: American Accounting Association, 1940), p. 140. Li disagrees with Paton and Littleton. "The statement made by Paton and Littleton, in other words, is
assets. John Leavitt and Earl Hanson point out the relationship between assets and claims when they say that "the corporation owns certain assets with which it conducts its business, and in turn the corporation owes an equal amount to its stockholders and creditors."¹⁴ Since the stockholder, like the creditor, has a claim according to his contract against the assets of the corporation, he may be considered a creditor rather than an owner.

Third, in economics, the investor is thought of as furnishing two functions in production: risk-taking and capital-furnishing.¹⁵ In accounting, the line between proprietorship and liabilities roughly corresponds to this economic division of functions. Actually, these aspects of ownership are inseparable; there can be no risk of loss without the furnishing of capital. The distinction between liabilities and proprietorship is one of degree. Paton says:

applicable only to instances where the corporation contemplates or is forced into liquidation--where the entity shield is pierced and where the business-continuity assumption is no longer valid. Under the entity concept with its implicit business-continuity assumption, capital supplying parties have claims against the corporation (not against assets) according to their contracts." David H. Li, "The Nature of the Corporate Residual Equity under the Entity Concept," The Accounting Review, XXXV (April, 1960), p. 260.


¹⁵Paton, op. cit., p. 60.
The individual or interest that assumes the larger element of risk in a business enterprise, and takes the major share of responsibility and control approximates the economist's "entrepreneur" and the accountant's "proprietor"; the individual or interest that furnishes capital but takes comparative little risk, and has slight but indirect control of ordinary operations, approaches the economist's "capitalist proper" and the accountant's "creditor."\(^{16}\)

Paton concludes that all interest, proprietary or otherwise that furnishes capital runs the risk of loss. Thus, the stockholders and the creditors can be grouped together in the same classification since both groups are bearing the risk of loss of their respective investments.

**Similarities between stocks and bonds.** The proponents of the entity concept contend that it is particularly applicable to a corporation because of characteristics ordinarily common to corporations. For example, the corporation secures capital from many sources, not just from stockholders, although its two main sources of capital are stocks and bonds. Although there is a definite legal distinction between stocks and bonds, from an economic viewpoint, it is often very difficult to distinguish between the two. Berle and Means lend support to this viewpoint:

> Though the law still maintains the conception of a sharp dividing line recognizing the bondholder as a lender of capital and the stockholder as a quasi-partner in the

\(^{16}\)Ibid.
enterprise, economically the position of the two have drawn together. Consequently, security holders may be regarded as a hierarchy of individuals all of whom have supplied capital to the enterprise, and all of whom expect a return from it. 17

There are many types of stock which exhibit the characteristics of bonds. For example, a preferred stock is similar to a bond in view of its protective rights, retirement provisions, and limited return. Paton says, "There seems to be no limit to the way in which the preferred stockholder, so called, can be safeguarded and endowed with rights and privileges ordinarily conferred upon none but a bondholder." 18 Many investors consider preferred stocks to be more like bonds than stock. One of the qualifications for a preferred stock is that "it meet the minimum requirements for a safe bond." 19

Just as there are stocks which are similar to bonds, there are also bonds which are similar to stocks. Income bonds, for example, have characteristics which are usually associated with stock. Interest need not be paid unless the company has sufficient earnings


18 Paton, op. cit., p. 71.

before interest charges to cover such interest payments. Thus, interest payments are analogous to dividends since both depend upon the earnings of the company. Although the income bond has a maturity date, in most cases the maturity date is so far in the future that repayment of the bond is not likely to be of any particular importance. In this respect, the income bond is similar to stock and particularly to preferred stock.

Paton further contends that it is often difficult to distinguish between liabilities and proprietorship in the case of the corporation with many types of stocks and bonds when he says:

To sum up, if all existing corporate stocks and bonds were to be arranged in a series according to degree of risk attaching to each, beginning with the most speculative types of common issues, the less conservative preferred stocks, the highly safe-guarded preferred issues and all the various grades of bonds grouped according to security, it would be impossible to draw a hard and fast line of division which followed security types and correspond to the proprietor-creditor grouping. 21

Corporation as a separate entity. The legal definition of a corporation as an artificial being existing separate and apart from

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20Ibid., p. 372.

21Paton, op. cit., p. 78.
the stockholders is often used as an argument for acceptance of the entity concept. 22 The debts and assets are those of the corporate entity and no individual stockholder has any title whatsoever to any corporate property. Paton says that "all that can be said of his interest, strictly, is that he has a equity in the total of the corporate assets." Furthermore, he says that the bondholder may be said to approach the stature of an owner much more closely than the stockholder.

A bondholder's claim to assets always ranks ahead of the stockholder in case of liquidation of the corporation. The only time a stockholder has a definite claim to specific corporate assets is when a dividend has been declared payable to him. In this case he becomes a corporate creditor in that the dividend becomes a liability ranking in importance with other unsecured liabilities of the company.

**Universality of the entity concept.** The entity concept applies to all types of business organizations, although many accountants associate the entity concept with the corporation and the proprietary concept with the sole proprietorship or partnership. Gilman contends

22 However, Sprouse states that both the proprietary theory and the entity theory have both found clear support in the law. Robert T. Sprouse, "Legal Concepts of the Corporation," *The Accounting Review* XXXIII (January, 1958), 37-49.

23 Paton, op. cit., p. 77.
that the only requirement for an accounting entity is that a double
entry set of records is maintained. Hord also agrees with Gilman on this point:

Double entry is based on the concept of the duality of a single business property. This duality is created through the separation of business property from their actual owners or placing these properties in the possession of a fictitious business entity which holds and operates such properties under an assumed trust arrangement between the business entity and the legal owners. This is purely an accounting assumption, and has no legal basis whatsoever. Because of the separation of the properties from the legal owners, and because of the varying legal status of these owners, it becomes necessary for the fictitious business entity to account for both kinds of goods making up the property in its possession and for the kinds of ownership claims attaching to these goods.

Paton and Littleton also maintain that the concept of the entity is important for an unincorporated as well as an incorporated business. They say that it is important from the standpoint of administration that business affairs be segregated from private or personal affairs. Even if the enterprise is not a corporation, and is powerless


26Paton and Littleton, loc. cit.
to hold legal title to property, accounting must regard assets dedicated to business purposes as being entity assets.

The entity viewpoint. If one views the business enterprise through the eyes of the entity, then the entity concept appears to be very reasonable. From the viewpoint of the entity, it makes very little difference whether the capital was obtained from creditors or owners; both types of capital suppliers require payment for the use of their funds. It is logical, then, to consider liabilities and proprietorship to be a part of the same division in the balance sheet.

Gilman summarizes the entity concept in the following manner:

The entity convention insists that the proprietor is a person or group, separate and distinct from the accounting entity; that the proprietor lends money to the accounting entity; that the accounting entity may or may not pay the money back to the proprietor, this being a matter determined by the proprietor's own wish and by any legal restrictions. 27

Proprietary Concept of Liabilities

Under the proprietary concept, the proprietor is the center of accounting, and all accounting processes relate to the basic nature of the proprietor's interest. There is a very significant distinction between liabilities and proprietorship, which distinction is reflected in the balance sheet by dividing the credit side into two separate sections.

27Gilman, loc. cit.
The accounting equation, assets minus liabilities equal proprietorship, is particularly applicable to the proprietary concept.

Charles Sprague adopts this viewpoint:

While the asset side contains concrete actualities, the other side deals with distribution of these actualities among those who have title to them and those who hold claims against them, the liabilities.

In algebraic language we might say that liabilities are negative assets and that proprietorship is measured by the algebraic sum of all assets positive and negative.28

Maurice Moonitz and Charles Staehling, like Sprague, support this concept of the accounting equation:

This form (of the accounting equation) permits a consistent legal interpretation of financial position. In any specific case, the assets are interpreted as the property of the business, or other accounting entity, the liabilities are interpreted as debts of the business, and the proprietary interest, also commonly referred to as proprietorship, net proprietorship, net worth, or proprietary equity, is interpreted as the property of the legal owners, whether sole proprietor, partners or stockholders.29

Moonitz and Staehling further contend that the above interpretation serves the practical purpose of satisfying creditors' claims through the application of assets employed in the particular business enterprise before considering the rights of the owner. This particular


interpretation is in accord with the legal relationships between creditors and owners since the claims of creditors rank ahead of those of owners. Furthermore, the owner of a business enterprise, unless the law provides limited liability, is responsible to the creditors even to the extent of his assets outside of the business.

**Proprietary concept and the corporation.** The advocates of the entity concept maintain that the proprietary concept is inappropriate for the corporate form of business. This is based on the idea of the corporation as a legal entity; that is, a being separate from its owners.

George Husband, one of the leading proponents of the proprietary concept, disagrees with this viewpoint; instead, he regards the corporation as "a group of individuals associated for the purpose of business enterprise, so organized that its affairs are conducted through representatives."\(^30\) In support of his idea, Husband points out that the law has frequently found it necessary to go behind the corporate fiction, and prescribe penalties for corporate officers as well as for the corporation. Furthermore, the income-tax law and regulations dispense with the corporate entity in the principle of constructive ownership, in the imposition of a tax upon corporations

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for improperly accumulating earnings, and in the surtax on personal holding companies. He concludes that "accounting theory would probably be more realistic if it accepted the fact that the corporation is an association of flesh-and-blood persons who enjoy special privileges because they have complied with certain legal requirements." 31

In addition to Husband, there are other accounting writers who object to the corporation being represented as a person apart from owners, managers, creditors, or other persons connected with the corporation. One of these writers, John Canning, objects vigorously to this personification of the corporation:

Imaginary entities have their proper place in the conceptual world of analysis in pure mathematics, but never in the statistical analysis of realities. Figures of speech may be useful as a device in exposition; but to hang the exposition of a statistical analysis and synthesis upon a figure of speech is to run the risk of conveying a memory of the figure instead of an understanding of reality. 32

One reason often cited by the advocates of the entity concept as a factor which precludes the use of the proprietary concept is the limited liability of the stockholders. Moonitz and Staehling disagree with the entity proponents on this point. They point out the significant

31 Ibid.

distinction between stockholders as owners of a residuary interest and creditors who have first claim to the assets:

The net effect of the stockholders' limited liability features in no way changed the nature of the proprietary position of the owners' of the enterprise. The extent of their interest is still limited to the value of the enterprises assets on the one hand and enterprise obligations on the other. What it did accomplish was to limit the claims of creditors to the debt-paying capacity of the enterprise, i.e., to the liquidation value of its assets.\(^{33}\)

The fact that the assets and debts of the corporate enterprise are those of the corporation rather than the stockholders is one of the reasons given by the entity advocates for the adoption of their viewpoint. Canning has a very unusual way of showing that the ownership of assets and debts by the corporation can be accounted for by the proprietary concept. A proprietor, he says, is not necessarily the owner of the business enterprise; he is only the "holder of assets."\(^{34}\) In the case of the sole proprietorship and partnership, the proprietor or asset-holder is also the owner of the business. In the case of the corporation, the stockholder is not the proprietor; the corporation is. The corporation is not an entity separate and distinct from the proprietor; the corporation, the proprietor, and


\(^{34}\)Canning, \textit{op. cit.}, pp. 47-53.
the asset-holder are one and the same person. Since the corporation, proprietor, and asset-holder are one and the same person, this makes the theoretical approach to the accounting problem of the corporation the same as that of the sole proprietorship and partnership. Under all types of business organizations, he contends, the affairs of the enterprise consist of (1) a set of services proceeding from designated items held by the proprietor (assets), (2) the interest of the proprietor, as recipient of the benefit of that set of services (proprietorship,) and (3) the set of services that the proprietor has become bound to render to others as incident to operating his business (liabilities).

He says further that the proprietary concept as ordinarily conceived has definite limitations under the corporate form of business. By legal definition, the stockholders do not own the corporate assets, and corporate liabilities are not debts of the stockholders. The proprietary concept is rationalized and unified under corporate conditions by identifying the corporation as the proprietor who, like the proprietor of other business organizations, holds all the assets and owes all the debts.

Differences between liabilities and proprietorship. There are many differences between liabilities and proprietorship, and these form the backbone of the proprietary concept. Sprague contends that the rights of others, or liabilities, differ materially from the
rights of the proprietor in the following respects:

1. The rights of the proprietor involve dominion over the assets and power to use them as he pleases even to alienating them, while the creditor cannot interfere with him or them.

2. The right of the creditor is limited to a definite sum which does not shrink while that of the proprietor is of an elastic value.

3. Losses, expenses, and shrinkage falls upon the proprietor alone, and profit, revenue, and increase in value benefit him alone, not his creditors. 35

For these reasons, Sprague says, the proprietor interest cannot be treated like liabilities and, furthermore, liabilities and proprietorship should be segregated in the balance sheet.

Although bondholders and stockholders are often thought of as contributors of capital and thus similar in nature, there are, nevertheless, many differences between stockholders and bondholders. The following summary gives the normal characteristics which distinguish bondholders from stockholders:

1. Claims of bondholders, together with those of other creditors, constitute prior claims, which must be met in full before anything can be paid to any stockholder.

2. The interest to bondholders is a constant claim, which must be met regularly in order to avoid insolvency regardless of earnings or financial position. Dividends to stockholders are possible only when earnings warrant, even then are paid only at the discretion of the board

35 Sprague, op. cit., p. 53.
of directors. Because of this difference the payment of interest upon a bond is spoken of as a fixed charge, while the dividends paid upon preferred stock are spoken of as contingent charges. Income bonds are an exception to this rule. Their interest is a contingent charge.

3. Bond interest is a claim for a fixed amount; payments to stockholders may or may not be a constant sum.

4. Bonds have a maturity date upon which the principal sum is repaid; stocks have none.

5. Bondholders have neither voting power nor voice in management so long as their obligations are met by the debtor corporation. The holders of stock, save when a certain class is specifically nonvoting by terms of its issuance, have power to control the business through the election of directors. 36

Although aspects of ownership may seem to be present in creditor as well as proprietary interests, there is a legal distinction between liabilities and proprietorship. Despite the fact that the assets may be heavily mortgaged and bankruptcy imminent, it nevertheless remains true that the assets are still legally owned by the proprietary interest of the sole proprietorship or partnership. The corporation is usually considered a legal person; however, this does not discount the fact that there is still a legal distinction between stockholders and creditors. The stockholders' interest represents a buffer existing for the purpose of the protection of the creditors' interest.

The proprietary viewpoint. When the business enterprise is viewed through the eyes of the proprietors and creditors, the use of the proprietary concept appears most logical. From the viewpoint of the proprietors and creditors, there is a legal distinction of some magnitude between them. No matter how closely a preferred stock resembles a bond, there is still a legal line drawn between the two. In Sprague's words, "The rights of others, or the liabilities, differ materially from the rights of the proprietor." The proprietary concept, as pointed out earlier, can be used for any form of business organization, whether sole proprietorship, partnership, or corporation. This universality makes it a useful accounting concept which can be applied to a modern business enterprise. The proprietary concept can be summed up in the following manner: proprietors are proprietors and creditors are creditors and never shall the twain meet.

Criticisms of the Entity and Proprietary Concepts

In recent years there has been a considerable amount of dissatisfaction with the entity and proprietary concepts. This dissatisfaction has led to a great deal of criticism of these two concepts, and in some cases, even to the development of new concepts. These

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37Sprague, op. cit., p. 46.
criticisms can be divided into two categories: (1) mixing of the entity and proprietary concepts in practice; and (2) adoption of a personality as the focus of attention.

**Mixing of the entity and proprietary concepts in practice.**

Some writers have pointed out that neither the entity nor the proprietary concepts actually are followed in practice; rather, practice seems really to mix the two, even to the point of vacillation. Husband, for example, writes:

> Accounting principles, as frequently presented, are not entirely consistent with either the entity or the representative (proprietary) viewpoint. While the accountant subscribes fundamentally to the entity theory, he appears to shift to the representative theory when it suits his convenience. 38

Gilman recognizes this same situation, but he argues that only inconsistency need be guarded against:

> Both the entity and proprietary conventions have value. Like all conventions, each contains an element of artificiality. Either is valuable so long as it is consistently maintained. It is only when an unconscious shift in viewpoint from one to the other occurs that there is danger of false reasoning. 39

The problems arising from the mixing of the proprietary and entity concepts in practice have led many accountants to believe that

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38 Husband, *op. cit.*, p. 252.

the only solution is to develop a new concept of the business enterprise. Others believe the solution to be strict adherence to one concept or the other.

Adoption of a personality as the focus of attention. The entity and proprietary concepts are often criticized because both adopt a personality as the focus of attention. In the case of the former, the entity assumes the role of a person, and thus the entity is the center of accounting. In the case of the proprietary concept, the proprietor is viewed as the center of accounting.

William Vatter objects to such use of personalities in accounting:

The weakness in these personalized bases for accounting is that the content of accounting reports will tend to be affected by personal analysis; and issues will be decided not by considering the nature of the problems but upon some extensions of personality—to reach or to support conclusions that are for the most part mere expediencies. Dependence upon personality and personal implications in accounting theory, even as a convention, does not contribute to that objectivity toward which all quantitative analysis is aimed. 40

Helmi Nammer also criticizes the proprietary and entity concepts; however, his criticisms are somewhat different from those of Vatter:

1. The proprietary concept of the accounting entity is based on assumptions with respect to ownership, management, and the ultimate objective of the business enterprise that have been greatly influenced by the legal nature and classical economic ideas of the firm. Such assumptions are not valid in the light of the economic facts of the corporate form and its activities.

2. The entity concept is also based on assumptions with respect to ownership, management, and the ultimate objectives of the business organization that cannot be justified on a legal basis.\textsuperscript{41} As a result of these criticisms, there have been a number of new concepts offered by various writers in recent years.\textsuperscript{42} These may eliminate the inconsistencies of the entity and proprietary concepts; however, at the same time, they also create problems in other accounting areas. In addition, these concepts, like the proprietary and entity concepts, do not conform to the legal concept of the business enterprise.

Summary

There are two concepts regarding the credit side of the balance sheet: the entity concept and the proprietary concept. The advocates

\textsuperscript{41} Helmi Mahmoud Nammer, "An Activity Concept of the Business Enterprise and Its Implications in Accounting Theory," \textit{The Accounting Review} XXXIV (October, 1959), 622.

\textsuperscript{42} For example, the enterprise theory, see Waino W. Soujanen, "Accounting Theory and the Large Corporation," \textit{The Accounting Review} XXIX (July, 1954) 391-398; the activity concept, see Nammer, \textit{op.}
of the former maintain that liabilities and proprietorship are not separate and distinct, but are interdependent parts of a larger class, equities. Furthermore, it separates the business enterprise from its owners and creditors, and all enterprise assets and debts are those of the entity, not the owners. Under the proprietary concept, the proprietor is the center of accounting, and all accounting processes relate to him. There is a definite legal distinction between liabilities and proprietorship, and this distinction is reflected in the balance sheet by dividing the credit side into two separate divisions, one for liabilities and one for proprietorship. Both the entity and proprietary concepts are universal in nature since they can be used for any form of business organization, whether sole proprietorship, partnership, or corporation.

There is a considerable amount of criticism of the two viewpoints. This criticism has led, in some cases, to the development of other concepts, but these have also proven to be deficient in many respects. Since the proprietary and entity concepts have been accepted in theory and practice, perhaps the best solution to the problem of selecting a concept of the business enterprise is for

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accountants to accept only one of these theories and by so doing, conformity can be achieved in financial reporting. Both of these concepts have their strong points, but it is believed that the entity concept is more applicable to the modern business enterprise. Thus, the entity concept will be employed in this work; however, the credit side of the balance sheet will still be divided into a liability section and a proprietorship section, and, at least to this writer, it makes very little difference whether the credit side is labeled "equities," or "liabilities and proprietorship."
CLASSIFICATION OF LIABILITIES

It is standard practice of accountants to separate liabilities into two groups: current or short-term and fixed or long-term. This classification scheme is designed primarily for the purpose of creditors, although it is also useful to managers and owners. Stephen Gilman says, "Credit necessities are, ..., largely responsible for the elements of present account classification, namely, current assets, fixed assets, and current liabilities, long-term liabilities, and proprietorship."¹

The classification of the balance sheet into current and long-term sections has given birth to the concept of working capital, which is usually defined as the difference between current assets and current liabilities.

Managers are especially interested in working capital since it is a measure of the fluidity of capital and an indicator of balance in the asset and liability structure of the business enterprise. The amount of working capital is also important to owners since it plays

an important part in determining the stability of the business enterprise. Short-term creditors are vitally interested in the amount of working capital from the standpoint of repayment of their claims against the company. Bond indentures, credit agreements, and preferred stock agreements sometimes contain certain provisions restricting corporate action which would cause a reduction or impairment of working capital.\(^2\) Thus, the working capital concept plays a very important role in the financial analysis of a business enterprise.

For this reason, then, it is felt that the retention of the present classification of liabilities and assets into current and long-term serves a very useful purpose, and furthermore, financial analysis based on the working capital concept is well established in both accounting and financial circles.

For any classification of liabilities to be meaningful, the basis of classification must be consistent with the basis of classifying assets. For example, if assets are classified on a time basis, then liabilities must also be classified in a like manner. If this procedure is not followed, the calculation of indices based on the working capital concept are apt to be misleading.

There are two concepts of the classification of liabilities:
(1) the older one which uses a certain period of time, usually one
year, as the basis for segregating liabilities into current and long-
term; and (2) the newer concept which is based on the operating cycle
as a means of distinguishing between current and long-term; in
addition, how the liability is to be paid is also considered.

Time Classification of Liabilities

Liabilities may be classified according to their maturity dates;
that is, liabilities maturing within a certain period of time are classi-
fied as current while all other liabilities are classified as long-term.
Generally speaking, the period of time is one year for the separation
of liabilities into current and long-term.

The one-year rule. The one-year rule is deeply ingrained in
accounting theory and practice. There are many accounting writers
who have advocated the use of the one-year rule for distinguishing
between current and long-term liabilities. Robert Montgomery, for
example, has long been an advocate for this rule. He states that,
"Current liabilities are obligations the maturity of which will not
extend beyond one-year from date of the balance sheet." 3 Other

accountants, among them Saliers, Hatfield, and Scott, also have recommended the use of the one-year rule for classifying liabilities.

Perhaps one of the reasons why the one-year rule is so widely accepted by accountants is its endorsement by the Securities and Exchange Commission. Regulation S-X states the following:

Items due and payable within one year shall in general be classed as current liabilities. However, generally recognized trade practice may be followed with respect to the exclusion of items such as customers' deposits and deferred income provided an appropriate explanation of the circumstances is made.

The one-year rule is highly arbitrary and inflexible, but it does have the advantage of establishing a definite basis for the classification of liabilities into current and long-term. Many accounting writers have recognized the difficulty of distinguishing between current and long-term liabilities. Hatfield says that there is "no clear line or demarcation between long-time debts and short-time

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debts. According to Kester, the "term 'current liabilities' cannot be standardized; it varies and will perhaps always vary according to custom and practice in a particular trade." These two writers, therefore, recognize the need for some sort of rule to aid the accountant in determining whether a liability is current or long-term. Further, these writers advocate the use of the one-year rule as the best solution to the classification problem.

The one-year rule is a very practical means of separating liabilities into current and long-term. It is a very rigid and capricious rule, but so are many other rules in accounting. If accounting is ever to be standardized, it will be necessary for many arbitrary rules to be adopted. Standardization is necessary for proper comparison of financial statements between different firms within the same industry. If individual accountants are given the privilege of deciding in each case whether a liability is current or long-term without the use of some arbitrary guide such as the one-year rule, it is evident that there will be no logical basis for comparison of financial statements.

8Hatfield, loc. cit.


10Hatfield, loc. cit.; Kester, loc. cit.
statements since each firm will classify liabilities according to the method selected by its accountant.

**Criticisms of the one-year rule.** The main criticism of the one-year rule is that it is highly arbitrary and inflexible. Anson Herrick, a voracious critic of the one-year rule, contends that the present practices of using the one-year rule "...do not rest upon a firm foundation; they are not draped over a firm theoretical skeleton so that they form a recognizable and logical body of thought, and, consequently, have become unassorted and unrelated bodies of gaudy and drab materials."\(^{11}\)

The use of the one-year rule can result in some rather odd situations. Herrick, for example, points out that the financial position of a firm having serial bond installments due within eleven and a half months from balance sheet date is not appreciably different from the position of having an installment due in twelve and a half months.\(^{12}\) It is not logical to adopt a practice which can result in a substantial difference in working capital if the financial statements where prepared a few days later.

Frequently the basis for classifying assets is entirely different from the classification of liabilities based on the one-year rule.

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\(^{12}\)Ibid.
One way to correct this problem is to adopt the one-year rule for classifying assets. Many accountants, however, contend that the one-year rule is neither appropriate nor logical for classifying assets. For example, the use of the one-year rule may require the separation of inventory items into current and fixed asset groups. Most accountants would object to such a classification because of the difficulty of determining when a particular item will be sold. This problem can be eliminated if the same basis for classifying assets is used for liabilities.

A New Concept of Liability Classification

The inadequacies of the one-year rule as a basis of liability classification led to the development of a new concept, which uses the operating cycle as a basis for separating liabilities into current and long-term. In addition, the classification of liabilities is determined by whether such liabilities are to be paid out of current assets or by the creation of other current liabilities.

The operating cycle. Bulletin 43 defines an operating cycle in the following manner:

The ordinary operations of a business involve a circulation of capital within the current asset group. Cash is expended for materials, finished parts, operating supplies, labor, and other factory services, and such expenditures are accumulated as inventory costs. Inventory costs, upon sale of the products to which such costs attach, are converted into trade receivables.
and ultimately into cash again. The average time intervening between the acquisition of materials or services entering this process and the final cash realization constitutes an **operating cycle**.\(^\text{13}\)

This concept of the operating cycle is generally held by the majority of accountants.

Herrick is one of the first accountants to use the operating cycle as a basis for classifying liabilities.\(^\text{14}\) Liabilities, Herrick says, which **require classification as current** embrace only those which will be liquidated in the ordinary course of the operating cycle from funds produced by the normal conversion of existing current assets. Herrick, in a later article, defines current liabilities as:

Those liabilities which **are a natural consequence or incidence** of the operating cycle of an enterprise and, in effect, are liens upon current assets in that the funds for their liquidation are on hand, or will be obtained, by realization upon existing current assets, indebtedness otherwise incurred which constitutes a withdrawal of working capital, and payments required to be made for long-term debt liquidation installments to the extent that such have accrued.

Current liabilities usually embrace:

1. Cash borrowed for prospectively temporary operating requirements.


2. Notes and accounts payable for merchandise, materials, services, and other operating requirements.

3. Taxes, interest, and other expense accruals, including reserve for deferred maintenance.

4. Other notes and accounts payable so circumstanced as to require payment out of existing current assets or the proceeds thereof.

5. Long-term debt retirement or sinking fund payments only to the extent that such have ratably accrued.

6. Deposits received or prospective sales and other services requirements.\(^{15}\)

Herrick's definition of a current liability excludes long-term debt installments due within a year from the current liability group, unless all or a portion of the installment has ratably accrued at statement date. For example, a company has a mortgage which is payable in annual installments of $1,000 on July 1 of each year. If the company prepares its balance sheet for the year ending on December 31, 1962, then Herrick says that $500 of the $1,000 mortgage installment due on July 1, 1963, has accrued and should be shown as a current liability. Furthermore, he says that accrued interest, rent, and other similar obligations are required to be stated only in the proportion of the future payments which have ratably accrued.\(^{16}\)


\(^{16}\)Ibid., p. 53.
On the other hand, long-term debt installments due within a year are generally classified as current liabilities. Such a practice, he contends, is no more logical than one which would require the total interest to be paid in the following year to be included as a current liability.

It appears that Herrick is not quite certain as to what constitutes a liability. In Chapter II, it was pointed out that one of the criteria of a liability is that it is a result of a present or past transaction. For example, a bond issue is a result of a past transaction between two distinct entities; therefore, the total amount of the bond issue represents the amount of liability. Accruals, on the other hand, are not external transactions, but represent either consequences of change in value connected with the continuation through time of contractual relations previously undertaken with outsiders, or changes in value with which outsiders are not directly concerned. Thus, only the amount which has accrued up to a certain date can be considered a liability. According to Herrick, if bond installments due within a year are shown as current liabilities, then any rent payments due within a year should also be shown as current liabilities. This is not logical since rental payments due within a year are not liabilities; however, any bond installments due within a year are liabilities, and thus, there is nothing illogical in showing them as current liabilities.
Herrick also contends that a debt created for the purpose of acquiring equipment under terms providing for payment over a period as short as one year may not be classified as a current liability. He says that such a liability provides for the installment payments to be made out of funds produced by the asset, and are not "liens" against existing current assets. Herrick apparently disregards the fact that it takes one complete operating cycle to produce any funds from the operation of the equipment. Thus, it follows that a payment due within the operating cycle must be paid out of existing current assets. Therefore, all payments due within the operating cycle should be classified as current liabilities. The other liabilities included in Herrick's current liability classification are those which will normally be liquidated within the operating cycle.

The American Institute of Certified Public Accountants take a position similar to that of Herrick. In Bulletin 43, current liabilities are determined in the following manner:

The term current liabilities is used principally to designate obligations whose liquidation is reasonably expected to require the use of existing resources properly classified as current assets, or the creation of other current liabilities. As a balance sheet category, the classification is intended to include obligations for items which have entered into the operating cycle, such as payables incurred in the acquisition of materials and supplies to

17Ibid.
be used in the production of goods or in providing services to be offered for sale; collections received in advance of the delivery of goods or performance of service; and debts which arise from operations directly related to the operating cycle, such as accruals for wages, salaries, commissions, rentals, royalties, and income and other taxes. Other liabilities whose regular and ordinary liquidation is expected to occur within a relatively short period of time, usually twelve months, are also intended for inclusion, such as short-term debts arising from the acquisition of capital assets, serial maturities of long-term obligations, amounts required to be expended in one year under sinking fund provisions, and agency obligations arising from the collection or acceptance of cash or other assets for the account of a third person. 18

The Institute's basis for classifying liabilities does not rest entirely on the operating cycle; in fact, the Institute relies on the one-year rule for determining the classification of liabilities not related to the operating cycle. The Institute, it seems, is attempting to integrate the one-year rule into its theory of liability classification. This theory gives the accountant an opportunity to use an outdated rule as a basis for classifying liabilities not related to the operating cycle. Although the Institute's approach appears to be practical, it is not very consistent. If the operating cycle is going to be the basis for classifying liabilities, then all liabilities should be classified according to this basis regardless of whether or not they are related to the operating cycle. Thus, any liability whose payment

18American Institute of Accountants, _op. cit._, pp. 21-22.
will fall due within the operating cycle should be classified as a current liability.

After the elimination of the inconsistencies discussed in the preceding paragraphs, both Herrick's and the Institute's concepts of current liabilities can be stated as follows: a current liability is a debt which will be paid within the operating cycle and which will reasonably be expected to require for its liquidation the use of assets properly classified as current or the creation of other current liabilities. This statement will serve as a basis for a restatement of the liability classification concept.

A restatement of the liability classification concept. If a liability is to be paid within the operating cycle, then it is classified as current. However, if the operating cycle is extremely short or, on the other hand, extremely long, then some arbitrary time period, such as one year, may be used. Whether or not a firm uses an arbitrary time period will be left to the individual accountant's own judgment. In addition, the accountant should also considered whether the adoption of an arbitrary time period will result in an improvement of the balance sheet for financial analysis purposes. Of course, liabilities not paid within the operating cycle are to be classified as long-term.

A current liability must be reasonably expected to require for its liquidation the use of current assets or be replaced by another
liability which in turn will be payable from current assets. Thus, a short-term liability to be liquidated by issuance of long-term debt or capital stock should not be classified as a current liability since neither long-term debt nor capital stock will be liquidated within the operating cycle. Also, a short-term liability to be liquidated by the use of non-current assets should not be classified as current. For example, a short-term note payable may be intended to be settled by transfer of a fixed asset to the creditor. Under these conditions, the note payable is not a current liability since it is not to be paid out of current assets.

Another important factor in the classification of liabilities is the source from which they have arisen. If a liability created a current asset, then it is usually proper to classify it as current. However, there are times when long-term debt or capital stock is used as a means of securing additional working capital. Under these conditions, neither long-term debt nor capital stock could qualify as current liabilities since they will not be paid within the operating cycle nor will they be paid out of current assets or by the creation of other current liabilities.

A current liability may create a fixed rather than a current asset. For example, machinery may be purchased on account. The account payable resulting from such a transaction is classified as current if it is to be paid within the operating cycle and will require
the use of current assets for its payment, or be replaced by another current liability.

The above concept of liability classification depends on the proper classification of current assets. It is necessary that assets be classified on a basis consistent with that of liabilities to have a meaningful balance sheet. Thus, it is assumed in this work that assets are classified on a basis consistent with the concept of liability classification presented here.

Summary

The one-year rule is used by many accountants as a means of separating liabilities into current and long-term. The use of the one-year rule has the advantage of establishing a definite guide for classifying liabilities. Furthermore, the one-year rule aids in the standardization of the balance sheet since each firm will classify liabilities the same way. The main criticism of the one-year rule is that it is highly arbitrary and inflexible, and therefore, the rigid application of this rule may lead to some misleading financial statements.

This criticism has caused a great deal of dissatisfaction among accountants and eventually led to the development of a new concept of liability classification. This new concept uses the operating cycle as a basis for classifying liabilities and furthermore, the classification of liabilities is determined by whether such liabilities are to be paid
out of current assets or the creation of other current liabilities. Both Herrick and the American Institute of Certified Public Accountants advocate a similar concept; however, there are some inconsistencies in their theories.

By eliminating these inconsistencies, the concept of liability classification can be restated as follows: a current liability is one which will be payable within the operating cycle; however, in cases where the operating cycle is extremely short or long, an arbitrary time period such as one year may be used. In addition, a current liability must also be reasonably expected to require for its liquidation the use of assets properly classified as current or be replaced by another liability which in turn will be payable from current assets. Any liability not meeting these requirements is to be classified as long-term.
V. ACCOUNTING FOR CURRENT LIABILITIES

A current liability, as defined in the Chapter IV, is a debt which will be paid within the operating cycle and which will reasonably be expected to require for its liquidation the use of assets properly classified as current or be replaced by another liability which in turn will be payable from current assets. The principal classes of liabilities which normally meet these requirements are short-term accounts and notes, accrued liabilities, dividends payable, agency obligations, advances and deposits, and estimated liabilities. However, there may be certain conditions under which a specific liability in this group will not qualify as a current liability. Thus, it is necessary for the accountant to examine carefully each liability to determine if it can be called a current liability.

Since it would be virtually impossible to include every current liability that may appear in financial statements, emphasis will be given in this chapter to those liabilities about which there is some controversy. Oftentimes there is some question as to whether an item is actually a liability, or if it is a liability, how will it be measured. It is the purpose of this chapter to determine if an item can qualify as a liability under the definition developed in Chapter II.
Furthermore, if an item is a liability, then its measurement will be discussed in terms of the principles of liability measurement presented in Chapter II.

Short-term Accounts and Notes

Accounts payable. In the narrowest usage the term "accounts payable" may be restricted to trade creditors accounts--liabilities created through the purchase of materials, merchandise, and supplies on account. This particular definition of the term "accounts payable" can be given the name of "trade accounts payable." Also "accounts payable" may include, in addition to trade accounts, virtually all unpaid bills and invoices, such as freight bills and invoices, water and light bills, et cetera. However, by classifying trade creditors' unpaid invoices as "trade accounts payable," the remainder of unpaid bills and invoices then may be classified as "other accounts payables."

Although there is no question that trade accounts payable are liabilities, there is some question as to the exact point in time a purchase on account becomes a liability. From a legal point of view, the passage of title to the merchandise is the point in time that a liability is created, but the exact time of title passage is often very difficult to determine.

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The merchandise is ordered, prepared, shipped, and received. When does title passage actually take place in this chain of events? Paton says that "it is expedient to assume that goods are effectively acquired when received, and to make an entry accordingly."\(^2\) The recording of the liability at the time delivery occurs provides a convenient and orderly method of liability recognition for accounting purposes.

There are some exceptions to this method for recording trade accounts payable. For example, if goods have been paid for in whole or in part, and set aside by the vendor, then it is necessary to recognize a liability even though the goods have not yet been delivered. Another occasion where the accountant should recognize a liability prior to the delivery of the goods is where there are goods in transit at the end of the accounting period. The inclusion or exclusion of the liability for goods in transit will depend on the terms of the sales contract. If the goods are shipped f. o. b. the supplier's plant, then the liability for the goods should be recorded since title passage occurred at the time the goods were delivered to the common carrier. On the other hand, a purchase in transit with the terms of the sales contract "f. o. b. destination" should be excluded from trade accounts payable

\(^2\)Ibid., pp. 263-264.
on the grounds that title does not pass until the goods are received by the purchaser.\(^3\)

There may also be circumstances where goods have been received, but title to the goods remains in the seller's hands until prescribed conditions have been met. For example, goods received on consignment are usually deemed to be the property of the consignor and not the consignee. In cases of this type, no liability is recorded until the consigned goods are sold.

Trade accounts payable should be recorded at the lowest figure at which they can be effectively discharged. This requires trade accounts payable to be recorded net of purchase discount. For example, X Company buys $1,000 worth of goods from Z Company, with a two per cent discount if paid within ten days. The following entries would be made to record this transaction:

On receipt of goods: 
\[
\begin{align*}
\text{Purchases} & \quad 980 \\
\text{Trade accounts payable} & \quad 980
\end{align*}
\]

On payment, if paid within discount period: 
\[
\begin{align*}
\text{Trade accounts payable} & \quad 980 \\
\text{Cash} & \quad 980
\end{align*}
\]

On payment, if not paid within the discount period: 
\[
\begin{align*}
\text{Trade accounts payable} & \quad 980 \\
\text{Discounts lost} & \quad 20 \\
\text{Cash} & \quad 1000
\end{align*}
\]

The Discounts Lost account is an expense account and should be included in the Income Statement.

The use of this method for recording purchases on account may require an adjustment for discounts lost at the end of the accounting period. For example, if an examination of outstanding accounts at the end of the accounting period shows that discounts amounting to $100 have been permitted to lapse, then the following entry can be made:

\[
\begin{align*}
\text{Discounts lost} & \quad 100 \\
\text{Trade accounts payable} & \quad 100
\end{align*}
\]

Thus, the correct amount of trade accounts payable appears in the balance sheet and, in addition, the loss from failure to take discounts is recognized.

For other accounts payable the same accounting procedures are used. However, in cases where the accounts payable are the result of purchase of services, the liability is recorded at the time the invoice or bill is received if it is received during the current accounting period. The accrual of liabilities for services performed, but not billed, will be discussed in the section on accrued liabilities.

**Bank notes payable.** Borrowing money from a bank by issuance of short-term notes is a well-known method of short-term financing. Often such notes are interest bearing and, in general, the amount received from the bank is the face amount of the note.
In Chapter II, it was pointed out that short-term interest bearing obligations, such as promissory notes, should be measured at their present value. In the case of an interest bearing note payable, the present value of the liability at the time the note is issued is the amount received from the bank. For example, X Company on January 1, 1962, borrows $1,000 from the bank on a note due in one year at a six per cent interest rate. The entry to record the issuance of the note is as follows:

1962  
Jan. 1  Cash  1000  
Bank notes payable  1000

The accrual of interest on December 31, 1962, is recorded as follows:

1962  
Dec. 31  Interest expense  60  
Bank notes payable  60

The balance in the Bank Notes Payable account on December 31, 1962 (assuming no other notes were issued during the year) is $1,060 which consists of $1,000, the amount received from the bank, and $60, accrued interest to date. This amount is also the present value of the liability on December 31, 1962.

This procedure is different from the usual accounting treatment for recording the accrual of interest. Most accountants would record the accrual of interest by a debit to Interest Expense and a credit to
Interest Payable. There is no particular advantage in separating interest payable from the liability for the amount received from the bank. In fact, the inclusion of both interest payable and the liability for the amount received from the bank in the same account results in the presentation of the total amount of the liability to the bank in one account.

The following entry would be made when the note is paid:

1963
Jan. 1  Bank Notes Payable  1,060
       Cash 1,060

There are times when a company issues a "non-interest-bearing" note to a bank at a discount. Assume, for example, that X Company gives the bank a $1,000, non-interest bearing, six-month note on a six per cent discount basis. The customary entry to record this transaction is as follows:

Cash 970
Prepaid interest 30
Bank notes payable 1,000

Paton objects to the above treatment of the $30.00 as prepaid interest. He says that there can be no "prepaid" interest since interest is the charge for the use of funds as time elapses.\(^4\) Furthermore, as pointed out earlier, the amount received from the bank is

the present value of the notes payable liability and should be recognized in the accounts. Therefore, in accordance with this viewpoint, the above transaction is recorded in the following manner:

\[
\begin{align*}
\text{Cash} & \quad 970 \\
\text{Bank notes payable} & \quad 970
\end{align*}
\]

When the note is paid (assuming no adjustments were required for accrued interest), the following entries are made:

\[
\begin{align*}
\text{Interest expense} & \quad 30 \\
\text{Bank notes payable} & \quad 30 \\
\text{Bank notes payable} & \quad 1,000 \\
\text{Cash} & \quad 1,000
\end{align*}
\]

In cases where adjusting entries are required before the note is paid, an entry can be made debiting Interest Expense and crediting Bank Notes Payable for the proper amount of accrued interest.

A note may be issued at a discount (or premium) even though it is an interest bearing note. For example, on January 1, 1962, a $1,000, five per cent note due in one year is discounted by the bank at a six per cent discount rate. This transaction is recorded in the following manner:

\[
\begin{align*}
1962 \\
\text{Jan. 1} & \quad \text{Cash} \quad 987 \\
\text{Bank notes payable} & \quad 987
\end{align*}
\]

On December 31, 1962, the following entry is made for the accrual of interest (the interest expense is computed at the effective interest rate of 7.023 per cent):
1962
Dec. 31 Interest expense 63
      Bank notes payable 63

The following entry would be made to record the payment of the note:

1963
Jan. 1  Bank notes payable 1,050
      Cash 1,050

Other notes payable. Purchases of merchandise, materials, supplies, and equipment are often acquired by issuance of a short-term note payable. In addition, a company often substitutes a note payable for an account payable. Usually these notes bear interest at a specified rate. The same procedure is used for recording notes of this type as for recording bank notes.

The recording of notes payable in this fashion assumes that the cost of assets received is equivalent to the face amount of the note. There are occasions where a "non-interest bearing" note is issued for assets which may be purchased for cash at less than the face amount of the note. For example, a "non-interest bearing" $1,000 note due in six months may be issued in exchange for an asset which may be purchased for $970 cash. The $30 difference between the face amount of the note and the cash price represents an implicit interest factor and should be recognized in the accounts. The liability for the note payable should be recorded as follows:
The entries necessary for adjustment of accrued interest and payment for the note are the same as those for non-interest bearing notes discounted at the bank.

An interest-bearing note may be issued for an asset whose cash price is different than the face amount of the note. Under these circumstances, the procedures are the same as those used for recording an interest-bearing note discounted at the bank.

**Amounts owed to employees, officers, etc.** Accounts payable to employees, officers, and other persons closely associated with the company should be recorded at the lowest amount at which they can be effectively discharged. In addition, notes payable to employees, officers, and other persons closely associated with the company should be recorded in accordance with the procedures outlined in the sections on notes payable.

Amounts owed to employees usually arise in connection with advances and deposits, and payment of traveling and other expenses by the employee for which he is entitled to be reimbursed. Such liabilities should be recognized at the end of the accounting period, and if the amount cannot be exactly determined, an estimate should be made.

Occasionally a company will borrow money or acquire assets from its officers or stockholders on a credit basis. The accounts and
notes resulting from such transactions should be separated from
other liabilities since the officers and stockholders are in a position
to withdraw their payments in full at the expense of outside creditors.
The SEC supports this position when it states that a corporation should
"state separately... (the) total of current amounts, other than items
arising in the ordinary course of business, due directors, officers,
and principal holders of equity securities other than affiliates."^5

Amounts due partners for salary and other items can generally
be considered as liabilities provided that such accounts do not repre-
sent profits or other funds which are in effect being retained in the
business as capital. ^6 Whether a particular account can be viewed
as a liability or proprietary item depends on the actual circumstances
involved.

Accrued Liabilities

Accrued liabilities are defined as that "proportion of liabilities,
applicable to a period up to and including a given date, which increases
commensurately with lapse of time but no part of which is due or


payable until after the given date..."^7

At the same time a credit is made to an accrued liability account, a debit is made to an expense account. There are, then, two factors to consider in the accruing of liabilities: (1) an expense is incurred in connection with the performance of service for a specific period of time; and (2) the payment for performance of the service is not made until after the end of the specific period of time. Thus, cost of services used during a specific period of time determines the amount of the accrued liability.

**Accrued interest.** The accrual of interest on current liabilities has already been covered in the sections on notes payable. The procedures of accounting for accrued interest on long-term obligations will be discussed in Chapter VI.

**Property taxes.** Real and personal property taxes are based on the assessed valuation of property as of a given date as determined by the laws of the state or other taxing authority. This date is usually referred to as the assessment date.

The legal liability for property taxes is generally considered as accruing at the moment of the occurrence of some specific event, rather than over a period of time. The exact date that a property tax

becomes a legal liability is usually determined by tax laws and court
decisions. 8

The problem of determining the period to which property taxes
should be allocated has been met in several ways. According to the
Institute, the following methods have been used for charging property
taxes against income of various periods:

(a) Year in which paid (cash basis),
(b) Year ending on assessment (or lien) date,
(c) Year beginning on assessment (or lien) date,
(d) Calendar or fiscal year of taxpayer prior to assess-
    ment (or lien) date,
(e) Calendar or fiscal year of taxpayer including
    assessment (or lien) date,
(f) Calendar or fiscal year of taxpayer prior to pay-
    ment date,
(g) Fiscal year of governing body levying the tax,
(h) Year appearing on tax bill. 9

The Institute states that the most desirable basis for account-
ing for property taxes is proration over the fiscal year of the govern-
ing body levying the tax. For example, X Company and the
governmental unit levying the tax have the same fiscal year—January 1

8 American Institute of Accountants, Committee on Accounting
    Procedures, Restatement and Revision of Accounting Research Bulletins,
    Bulletin No. 43 (New York: American Institute of Accountants, 1953)
    p. 82.
9 Ibid., p. 83.
to December 31. Furthermore, assume that property taxes become
a legal liability on April 1, the billing date. The entry to record
receipt of the tax bill of $1,200 on April 2, 1962, would be:

1962
April 2   Property tax expense      1,200
                 Property tax payable      1,200

The property tax expense for 1962 is $1,200, the amount in
the Property Tax Expense account at the end of 1962.

This procedure may be objected to on the grounds that the en-
tire amount of the tax should logically be accrued by the date it
becomes a legal liability. Therefore, property tax should be accrued
by charges to income during the year prior to the legal liability date.
In accordance with this viewpoint, the above example would be recorded
in the following manner (assuming that the estimated property tax is
the same as the actual amount of the tax):

1961
Dec. 31   Property tax expense      900
                 Property tax payable      900
    To record the accrual
    of property tax for last
    nine months of 1961

1962
April 2   Property tax expense      300
                 Property tax payable      300
    To record the accrual
    of property tax for first
    three months of 1962
    upon receipt of tax bill
An alternative accounting procedure would be to set up the full amount of the liability on the legal liability date and then allocate the amount in the corresponding asset account to income during the following year. Under these circumstances, referring to the previous example, property tax would be recorded as follows:

1962
April 2     Prepaid property tax       1,200
            Property tax payable       1,200

Adjusting entries would be made on December 31, 1962, to record the amount of property tax expense applicable to 1962.

Any of these three methods of recording property tax is satisfactory as long as it is consistently followed and the full amount of the liability is recognized in the accounts on the legal liability date. However, the last method discussed is recommended since it is in agreement with the criteria for liability recognition set forth in Chapter II.

**Income taxes payable.** Income taxes, unlike property taxes, are generally considered to accrue as income is earned; that is, the earning of income gives rise to the tax. Although the tax does not become due until after the income is earned, the company has still incurred a liability for income taxes which it must pay at a later date.

The computation of federal and state income taxes for a complex business enterprise under the present income tax laws is a very
difficult and lengthy process. It is common practice to provide a conservative estimate at the end of the year for statement purposes, which will be subject to adjustment when the final return is prepared.\(^\text{10}\)

The estimate of the income tax liability should always be as accurate as possible so that only small corrections will be required in the following period.

The estimation of income taxes for interim statements is very difficult because the amount of income tax for a portion of the taxable year is dependent on the estimate of taxable income for the entire year.\(^\text{11}\) Thus, the reliability of such estimates for interpretation purposes is of questionable value and therefore, should be called to the attention of the financial statement reader by the use of a footnote.

**Deferred income taxes.** In recent years there has been a considerable difference between "taxable" income and "accounting" income because accounting records are often kept on a basis different from that of tax records. For example, accelerated depreciation may be used for tax purposes while straight-line depreciation is used for accounting purposes.

\(^{10}\)Wixon, *op. cit.*, p. 20-7.

\(^{11}\)Ibid.
In order to improve the matching of expenses and revenues, some accountants have computed income taxes on accounting income for financial statement purposes. If taxable income is less than accounting income, the additional income tax, computed on the difference between taxable income and accounting income, results in a credit item usually referred to as "deferred income taxes."

There is a considerable amount of controversy among accountants on whether deferred income tax is actually a liability. This controversy can easily be resolved if deferred income tax is considered from the standpoint of the characteristics of a liability; that is, (1) if it is an obligation; (2) if it requires a future outlay of money or its equivalent; (3) if it is a result of a past or present transaction; and (4) if it is subject to reliable estimation.

Deferred income tax will not qualify as a liability under the first characteristic since it is not an obligation. The term "obligation" connotes a duty to deliver assets or perform service for someone outside of the business enterprise. Furthermore, it also implies that there are claims or series of claims against the company which require settlement in the future. In the case of deferred income tax, there is no duty on the part of the company to deliver assets to the United States Treasury since this agency has no claim against the company.
Arnold Johnson expresses this same viewpoint when he says:

Do the accounts (deferred income taxes) represent liabilities for the payment of certain income taxes, future payables? It is absolutely certain, that a liability for deferred income taxes does not exist as of the date of a current balance sheet. It is absolutely certain, further, that currently there is no income tax creditor. There is no claim by the United States treasury. And the corporate taxpayer does not consider the credit values in question to be liabilities. By the test of common sense, the company knows the values are not liabilities. 12

J. E. Sands contends that deferred income taxes are similar to credit balances set up to cover such things as estimated future claims against warranties. 13 He says that these items are described as liabilities even though neither the present amount nor the individuals to whom the liabilities will be paid are known.

Deferred income taxes and warranties are similar in several respects; however, there is one significant difference between these two items--a legal contract. At the time a product is sold a contract is entered into by the customer and the vendor stating that the company will be liable for defective products or unsatisfactory performance.


13J. E. Sands, "Deferred Tax Credits are Liabilities," The Accounting Review, XXXIV (October, 1959), 589.
In the case of deferred income taxes, there is no contract between the taxpayer and the Treasury Department for payment of these future taxes.

Warranties are liabilities in that the company has a definite obligation to fulfill its contract with the customers for replacement or repair of products already delivered. On the other hand, deferred income taxes are not liabilities in that no contract exists between the government and the taxpayer for payment of deferred income taxes. Furthermore, the government does not even recognize the existence of any such obligation for future income taxes.

Deferred income taxes are a result of past transactions and they require, under the going concern concept, a future outlay of funds. However, there is some question as to whether such taxes can be accurately estimated. Maurice Moonitz says that "the major barrier to a satisfactory solution for the problem of tax allocation in any specific case is the existence of uncertainty as to the level of taxable income and of tax rates in the future--no one can be absolutely certain that the item will ever again enter into anyone's tax computation." 14 Willard J. Graham, however, points out that deferred

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income taxes do depend upon realization of future taxable income, and that such anticipation of income is unwarranted.\textsuperscript{15} However, he says that the validity of many asset values also depend on the presumption of future net income; that is, unless a company continues operating at a profit it cannot justify fully the carrying of any assets at values that can be fully realized only by earning of future net income. Furthermore, he says that most asset values would shrink substantially if continued operations at a profit were not anticipated. Therefore, he contends, both asset values and deferred income taxes are "legitimate," even though their "realization" depends upon future taxable income.\textsuperscript{16}

Deferred income taxes do not qualify as liabilities since they are not obligations, and furthermore, the difficulty of forecasting future taxable income and tax rates casts some doubt on the reliability of the amounts designated as deferred income taxes.

Since many accountants hold that deferred income taxes are not liabilities, they have devised other ways of presenting this credit item in the balance sheet.


\textsuperscript{16}Ibid.
One possibility which has been suggested is to include the amount in the stockholders' equity. This suggestion has not been well received for it seems to defeat the purpose of income tax allocation in the first place. If these deferred taxes arise from an attempt to correctly state income, then both the deferred tax and related tax expense would appear in stockholders' equity which, of course, would be equivalent to having never made the allocation to future periods. Furthermore, deferred taxes should not be included in stockholders' equity since they do not represent earnings or contributed capital.

Another possibility is to use the deferred tax account as a valuation account to be offset against the related asset account. It is argued that the loss of tax deductibility in an asset is a loss of value, and that this may be properly reflected in the accounts by crediting the deferred tax directly to the allowance for depreciation account or some new valuation account. The logic of this argument has attracted many accountants, and it is regarded as an acceptable method by the American Institute of Certified Public Accountants.  

One last possibility is to disclose the difference in taxes on

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accounting income and taxable income through the use of a footnote or separate schedule, as suggested by Thomas Hill:

It is proposed that all causes for difference between taxable and reported net income before tax of a period be shown in a separate supporting schedule, that these be classified as permanent or temporary and that with respect to temporary (timing) differences the expected period or periods of offset be indicated.  

This is an acceptable method for those who do not believe in inter-period allocation of income taxes.

Wages, rents, and royalties. At the end of the accounting period wages may be owed for work performed if the firm's payroll date and the balance sheet date do not correspond. Therefore, it is necessary to make an entry to record the amount of the liability and the related wages expense. Accruals should include, in addition to hourly wages and salaries, special compensation, estimates of bonuses accrued, commissions earned, et cetera.

There is also the problem of whether to record the liability for the employer's payroll taxes. Some accountants omit the tax liability because the related expense item is not deductible for computing income subject to federal income tax. Also the tax is sometimes

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omitted from the accounts because it may be of such a small amount
that its omission will have very little effect on either liabilities or
reported income. On the other hand, there is sound justification
for recording the tax since a liability as well as an expense has
accrued. It is just as logical to record accrued payroll taxes as it
is to record accrued wages.

Where property is operated under a short-term lease agree-
ment in which rents are payable currently to the lessor, it is neces-
sary to record the liability and related expense at the end of the
accounting period for accrued rent applicable to that period. The
accrual of rent should be done in accordance with the terms of the
lease agreement. The problems of accounting for long-term leases
will be covered in Chapter VI.

All royalties accrued at the end of the accounting period should
be recorded. Some royalty contracts provide for a minimum payment
even though no liability may accrue on a unit basis.\footnote{Norman J. Lenhart and Philip L. Defliese, \textit{Montgomery's Auditing} (8th ed.; New York: The Ronald Press Company, 1957), p. 342.} For example,
coal leases often call for minimum annual payments regardless of the
fact that the leasing company may not have extracted any coal. Under
agreements of this type, the liability for the minimum annual payments
should be recorded even though there has been no production or sale.
Dividends

Common dividends. A dividend becomes a debt owing to the stockholders when it is fully declared, and, if not paid, a stockholder can sue the corporation and receive a judgment for the amount of the unpaid dividend. Since the dividend becomes a liability of the corporation on the date it is declared, this is the logical date to record dividends payable.

In the case of cash dividends, the amount to be recorded as a liability is the amount of cash to be paid out to stockholders; however, where the dividend is payable in non-cash assets, a problem arises as to what amount should be recorded as a liability. Assume, for example, the directors of a particular company declare a dividend payable in government bonds with a book value of $49,000 while the market value is $51,000. It is common practice to record the dividend at the book value of the government bonds, $49,000, although the market value is the effective amount of the dividend liability. The company could sell the government bonds for $51,000 and then use the money to pay a cash dividend. From the company's viewpoint, it has given up assets with a market value of $51,000, and this amount should be reflected in the dividends liability account. The company

recognizes the $2,000 appreciation by a credit to income on the occasion of the dividend declaration. Thus, the dividend liability should be measured at the market value of the assets to be delivered to the stockholders.

Dividends declared in script or other written promises to pay are handled like cash dividends as far as accounting procedures at declaration date are concerned. For example, the directors of a corporation declare a dividend of $300,000 in one-year notes, bearing a six per cent interest rate. At date the dividend is declared, an entry can be made debiting Retained Earnings and crediting Dividend Payable in Notes for $300,000. When the notes are distributed to the stockholders, an entry can be made debiting Dividend Payable in Notes and crediting Notes Payable, in accordance with the procedures set forth in the sections on notes payable.

There may be circumstances under which a company will declare a dividend payable in the form of a long-term obligation of the declaring company. In cases of this type, the amount of the dividend liability should be the fair market value of the long-term obligation—the amount at which the obligations could presumably have been issued for cash by the corporation. The use of the fair market value rather than

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22See Chapter VI for a discussion of the measurement of long-term liabilities.
the maturity value results in a more meaningful measure of the liability since it is consistent with the results which would appear if the long-term obligation had been issued for cash.  

Preferred dividends. Preferred dividends, like common dividends, become a liability of the corporation on the date they are declared and should be recorded at this time. The accounting procedures for common dividends can be applied equally as well to preferred dividends.

There is one problem, however, which does not occur with common dividends--preferred dividends in arrears. The arrearage does not represent a liability since it is not an enforceable right on the part of the shareholder; unless and until there is a declaration by the board of directors he can take no action to collect back dividends. The preferred dividends arrearage should be disclosed in the balance sheet. A footnote is often used to state the amount of the arrearage. Paton and Paton recommend the following procedure:

If there is any balance in retained earnings, . . . , there is something to be said for charging the arrearage thereto--until such is absorbed--and crediting a special

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24Ibid., p. 116.
account entitled "retained earnings applicable to preferred dividends arrearage," and in this situation, too, there is merit in showing the earning's balance as a part of preferred stock equity. 25

Advances, Deposits, and Agency Obligations

Advances and deposits. Advances by customers for the future delivery of products or performance of service is often referred to as "deferred income." Paton objects to the use of this term as an account title for advances from customers. He points out that net income for the period, if any, is the amount by which total revenue for the period, represented by the sales value of the delivered product, exceeds all the expenses, losses, and taxes applicable to such revenue. Therefore, he questions the accountant's justification of the use of the word "income," even with the qualifying term "deferred" attached, to describe the amount of a customer advance. 26

There is an expression which says, "Why not call a spade a spade." Why not, then, call an "advance by customers" an "advance by customers?" Therefore, it is suggested that the term "advances by customers" instead of "deferred income" be used to describe the

25Ibid., p. 117.

liability for advances by customers for future delivery of goods or performance of service. Such liabilities should be measured at the amount of the advance payment made by the customer.

Under circumstances where notes receivable are discounted for customers, it is the general practice to record the amount of the discount as "unearned interest income," and to include this account among the liabilities in the balance sheet. This account is not a liability since it requires no future outlay of funds. Paton suggests that the amount of the discount should be deducted from the face amount of the note for reporting purposes. However, in order to be consistent with the method for recording discounted notes payable, a notes receivable discounted for a customer should be recorded net of the discount.

The practice of including in liabilities the account called "deferred gross profit on installment sales" is particularly objectionable. There is no liability on the part of the company since this account requires no future outlay of assets. The merchandise has already been delivered to the customer and thus the company has discharged its liability for future delivery of assets.

\[\text{Ibid.}, \ p. \ 40.\]

\[\text{For a suggested method for recording installment sales, see Paton and Paton, op. cit., pp. 283-289.}\]
Companies sometimes require deposits to secure payments of bills. Such deposits are quite common in the public utility field. These deposits are liabilities of the company since the customer has the right to reclaim the deposit after a certain period of time has elapsed or upon discontinuation of service. If interest is to be paid on the deposits, the interest should be accrued and added to the amount of the deposit liability. The account should be adjusted periodically for those deposits whose return is unlikely.

Deposits are often required in certain industries to cover the cost of containers in which the product is shipped, and these deposits are to be refunded when the containers are returned. Container deposits are usually recorded by a debit to accounts receivable and a credit to a container liability account. The container liability account is not a liability since no deposit has been made by the customer; thus, there is no obligation to return any money to the customer if he returns the container. Perhaps a memorandum entry could be made for the returnable containers and if the containers were not returned after a reasonable length of time, an entry could be made charging the customer's account for the cost of the unreturned container.

29 Lenhart and Defliese, op. cit., p. 329.
If cash is received as the deposit, an entry can be made debiting cash and crediting a liability account for the amount of the deposit. Customers often do not return containers for which they have made a cash deposit. The deposit liability account should be adjusted periodically so that it reflects the amount of refunds expected to be paid for returned containers. The liability estimate can be based on previous experience or a specific period of time may be used under the assumption that containers not returned during this period of time will probably never be returned. The cost of containers not expected to be returned can be eliminated from the container asset account, and any difference charged to an expense account or credited to an income account.

Agency obligations. These obligations arise when cash or other assets are collected or accepted for the benefit of third parties. Obligations of this type may result from social security taxes on salaries and wages and the statutory withholding for income taxes deducted from employees' compensation by the employer; taxes on dividends paid to foreign stockholders withheld by the corporation paying the dividend; taxes on rents, royalties, or other forms of income paid to nonresident aliens, foreign partnerships, or foreign corporations withheld by the payers of such income; local taxes on wages or on retail sales collected by the payer or vendor; and union dues,
hospitalization and group insurance premiums, amounts due on contributory pension contracts, and other items withheld from wages paid to employees. 30

Collections made for the benefit of third parties are liabilities of the collecting agency and should be shown as such on the balance sheet. The amount to be recorded as a liability is the amount collected for the third party.

Estimated Liabilities

Warranties and guarantees. Warranties and guarantees have all the characteristics of liabilities. They are obligations in the sense that there will be claims against the vendor for repair and replacement of defective products. Although the exercise of this claim depends upon the customer's dissatisfaction with the product, nevertheless both the vendor and customer recognize that such a claim exists, and may be exercised by the customer if the product proves to be defective.

Warranties and guarantees are certainly a result of a past or present transaction—the sale of the product—and will require a future outlay of assets or performance of service. This future outlay can

30Ibid., p. 326.
be estimated with some degree of accuracy. Past experience can be used in estimating the amount of the future outlay of funds involving established products. In the case of new products, the estimate can be based on experience with similar products or on engineering tests undergone by the new product.

The estimated liability for the future repair or replacement of products sold under a warranty or guarantee is usually recorded by a debit to an expense account and a credit to a liability account in the period in which the products are sold. Paton and Paton suggest an alternative procedure for recording the estimated liability.  

Assume, for example, that X Company sells fifty units of mining equipment for a total price of $500,000, collectible in full on delivery. The agreement provides that X Company will keep the equipment in good running order for one year from date of delivery, including replacement of minor parts, without additional compensation. In addition, assume that the equipment is delivered at the end of the year, and that the servicing cost incurred in the following period is exactly the estimated amount of $25,000. Paton and Paton would make the following entries to record this information.

\[\text{31 Paton and Paton, } \textit{op. cit.}, \text{ pp. 344-345.}\]
At end of first year

<table>
<thead>
<tr>
<th>Cash</th>
<th>Sale of equipment $500,000</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Advance by customer</td>
</tr>
<tr>
<td></td>
<td>to cover maintenance</td>
</tr>
<tr>
<td></td>
<td>service</td>
</tr>
<tr>
<td></td>
<td>To record sale of</td>
</tr>
<tr>
<td></td>
<td>equipment</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Advance by customer</td>
</tr>
<tr>
<td></td>
<td>to cover maintenance</td>
</tr>
<tr>
<td></td>
<td>service</td>
</tr>
<tr>
<td></td>
<td>Cash</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Payment of maintenance</td>
</tr>
<tr>
<td></td>
<td>expense for servicing</td>
</tr>
<tr>
<td></td>
<td>equipment sold</td>
</tr>
</tbody>
</table>

The method of recording the liability for future maintenance costs certainly has merit. For one thing, a company which sells equipment and agrees to maintain it in good working order has to include in its sales price enough to cover these future costs. From the customer's standpoint, the price he pays for the equipment certainly includes a portion for the future maintenance of the equipment. Thus, it is logical to consider the sales price as consisting of two portions: (1) an advance by the customer to cover future service costs; and (2) the actual amount of revenue received from sale of the equipment.

If the sale of the above equipment was on a credit basis, and no part of the total price had been collected by the end of the first year, it is not logical to set up an "advance by customer" account since no advance payment has been received from the customer. Paton and Paton say that a liability set up at the time of sale is "nothing more
than an offset to an overstated receivable."\textsuperscript{32} They recommend that the following entries be made to record a credit sale under these circumstances:

<table>
<thead>
<tr>
<th>When sale was made</th>
<th>Accounts receivable 475,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sale of equipment</td>
<td>475,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Payment on Account</th>
<th>Cash 500,000</th>
<th>Accounts receivable 475,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Advance by customer to cover maintenance service</td>
<td>25,000</td>
<td></td>
</tr>
</tbody>
</table>

This method appears to be appropriate for credit sales involving a future maintenance agreement. In addition, it can be easily modified to include sales made on an installment basis.

The amount to be credited to the liability account, as mentioned earlier, should be based on as accurate an estimate as possible. If the amount in the liability account is insufficient to cover the expense incurred for maintenance, then the additional cost may be charged against the income of the period. However, if the actual expenditures for maintenance are less than the amount in the liability account, this difference can be credited to an income account.

The above procedures can also be used where products are sold with a warranty or guarantee for repair or replacement of defective

\textsuperscript{32}Ibid., p. 343.
products. For example, a company which sells electric toasters may guarantee the toaster against defects in workmanship and parts for a one-year period. Every person who buys a toaster probably will not require a repair or replacement. Nevertheless, a portion of the sales price can be considered as being similar to an insurance premium; i.e., each person who buys a toaster during the accounting period is going to share part of the total expense of repairing and replacing defective toasters sold during the period, and his share of this total expense is included in the selling price. Furthermore, the company considers (or should consider) this total expense in setting the sales price and, therefore, adds enough to the sales price to cover these future costs.

The entries to record the estimated liability for warranties and guarantees for a specific accounting period can be made at the end of the period by a debit to sales and a credit to a liability account. This same procedure can be followed for each accounting period, and if it is discovered at a later date that the amount in the liability account does not correctly reflect the future liability for warranties and guarantees, an adjustment can be made in the method of estimating the liability in order to correct either an understatement, or an overstatement of the estimated liability. This method is a practical solution to the problem of accounting for warranties and guarantees where the
number of units sold is so large as to preclude the use of the procedures described earlier.

Sales returns and allowances. Sales returns and allowances are generally considered to be a reduction of the total sales for a specific accounting period. Thus, the typical income statement shows sales returns and allowances as one of deductions from gross sales in arriving at net sales. Any estimate, then, of sales returns and allowances applicable to future periods will reduce the gross sales in the period in which the sales were made.

Sales returns and allowances are often made on cash sales. From the standpoint of the company, it must return a portion of the cash received from sales to the customers who return merchandise. Thus, the portion of cash sales which is going to be returned to customers can be considered a liability since it is an obligation of the company; that is, a customer has a claim against the company if he decides to return a product sold to him by the company. The company also recognizes that it has a duty to refund the cash paid by the customer if the product is returned.

It was pointed out earlier that sales returns and allowances are generally considered to be a deduction from gross sales. Thus, cash sales may be recorded net of the expected sales returns and allowances. Assume, for example, that Z Company has cash sales for the week of
$10,000 and that out of this figure $500 was expected to be refunded to customers for returned products. The following entries are made to record this information:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>10,000</td>
</tr>
<tr>
<td>Cash sales</td>
<td>9,500</td>
</tr>
<tr>
<td>Liability for estimated future sales returns and allowances</td>
<td>500</td>
</tr>
</tbody>
</table>

An alternative procedure would be to debit a sales returns and allowance account and credit a liability account for the amount of estimated sales returns and allowances, $500. The sales return and allowance account would then be shown as a deduction from gross sales in the income statement.

If goods subject to returns and allowances are sold on account, then the estimated future returns and allowances on these sales may be recorded as a debit to a sales returns and allowance account. This is shown as a reduction of gross sales on the income statement. A credit can be made to an allowance for sales returns and allowance account which is shown as a reduction of accounts receivable on the balance sheet. The procedure of showing the allowance as an offset against accounts receivable on the balance sheet results in the presentation of the estimated amount to be collected from customers in the future.

The accounting procedures for estimated sales returns and allowances are similar to those for estimated bad debts. An entry
can be made debiting an expense account (or sales) and crediting an allowance account for sales on account or a liability account for cash sales for estimated returns and allowances on sales made during the period. The balance in the allowance or liability account can be examined from time to time to determine if it correctly reflects the amount the company is expected to have to give credit or pay to customers for returned merchandise. If the allowance or liability account is overstated, or on the other hand understated, then an appropriate adjustment will need to be made in the method of estimating sales returns and allowances.

**Estimated collection costs on receivables.** Estimated collection costs on receivables are not liabilities. The company has no obligation to pay out funds in the future since there are no claims against the company. For a claim to exist, someone outside of the business must have performed some sort of services for the firm for which he has not yet been paid. In this case, there has been no performance of service by a person outside of the company in connection with the future collection of accounts. Thus, there is no claim against the company by an outside entity.

Paton and Paton have essentially the same viewpoint:

From a practical standpoint, there is no serious objection to this procedure (the practice of charging an expense account and crediting a "reserve for billing and collection costs" account for estimated collection costs on receivables).
However, it does involve recognition of costs not yet incurred—measured either in terms of expenditures or liabilities effectively assumed—and thus creates a problem of interpretation with respect to the reserve account. This account is clearly not a liability, under any reasonable definition of the term...33

The recognition of future collection costs on receivables is desirable from the standpoint of correct matching of expense and revenue. Paton and Littleton state:

The difficulty is resolved when it is perceived that adjustments for after-costs (future collection costs) are a part of the process of measuring the revenue applicable to a particular period on a sales basis. The charge for the estimated amount of such costs then becomes a direct deduction from a revenue account that would otherwise be overstated, in its current effect, and the corresponding credit becomes an offset to outstanding receivable as a part of the process of reducing the gross amount to the net amount to be realized.34

Estimated loss on purchase commitments. It is common accounting practice to recognize losses arising from firm purchase commitments due to a decline in the price of the goods contracted for. Bulletin 43 indicates that such losses "measured in the same way

33Ibid., p. 341.

as are inventory losses, should, if material, be recognized in the
accounts and the amounts thereof separately disclosed in the income
statement.\textsuperscript{35} The general accounting procedure for recognizing
such losses is to debit an expense account and credit a liability
account called "provision for losses on purchase commitments."

Moonitz disagrees with this procedure for recording estimated
losses on purchase commitments. He says:

The "loss" is not the debt--presumably we owe the
full amount contracted for. Literally the "loss" is
the estimated amount of damages to be paid if we
breach the contract. But we don't need this type of
fragmentation. If we introduce into our double entry
system both the asset (goods on order) and the liabil-
ity (accounts payable for goods on order), we have
no problem with respect to the liability. The loss
problem then becomes a problem in inventory valua-
tion and might be solved, for example, by application
of the cost or market rule. Under this type of
analysis, the exceptional nature of the purchase
commitment case disappears.\textsuperscript{36}

Moonitz considers "goods on order" to be an asset. In recent
years there have been a number of accounting definitions of the term
"asset" which stress the future economic benefits or services to

\textsuperscript{35}American Institute of Accountants, \textit{Bulletin 43}, p. 35.

be derived from an item. Under these definitions, "goods on order" would certainly be considered an asset. The problem, however, is not one of definition, but of measurement. The purchase price of the goods to be acquired certainly cannot be used as a measure since such goods have not yet been acquired; what the company has actually acquired is a right to purchase such goods. The problem now becomes one of properly measuring this right. It is virtually impossible to measure the right to purchase goods since the company acquiring the right has given up neither an asset nor assumed a liability. It might be said that the company is giving up its right to buy goods from other sources, but how could a dollar amount be assigned to this right. Thus, it is not logical to recognize "goods on order" (or perhaps a better title would be "right to purchase goods") in the accounts since this item cannot be objectively measured;

therefore, if no asset value is recorded, then no liability can be recorded. However, "goods on order" is still an asset, but it is an asset whose value is indeterminate.

When there is a decline in the price of goods contracted for, it results in a decline in the value of the right to purchase goods since the company could conceivably purchase the goods from other sources at a lower price. Thus the right no longer possesses any economic benefit to the company, and this loss in economic benefit can now be measured objectively; that is, the difference between the price contracted for and the price at which the goods could be purchased elsewhere.

As pointed out earlier, the general accounting procedure for recognizing losses on purchase commitments is to debit a loss account and credit a liability account for the amount of such losses. However, since the right to purchase goods is an asset, and a decline in the price of goods contracted for results in a decline in the value of this asset, then the credit part of the above entry should be made to an asset account, not a liability account. The right to purchase goods cannot be recorded in the accounts at the time a contract is entered into since it cannot be objectively measured. Therefore, since no asset value has been recorded in the accounts, it would not be logical to recognize a "loss" resulting from a decline in value of the right to purchase goods.
Reserve for repairs. A reserve for repairs is not a liability, although it does involve a future outlay of funds which can be estimated with some degree of accuracy; however, the outlay of funds involves a future transaction, not a present or past transaction. When a major repair is made, the company incurs a cost which may be amortized against income over its useful life; the company has not paid off an obligation accumulating from past periods.\textsuperscript{38} Furthermore, there is no claim against the company since the repairs have not yet been made.

Paton and Paton state that "the most reasonable way to handle the item (reserve for repairs) is as a \textit{contra} to assets kin to accrued depreciation."\textsuperscript{39} The justification for this procedure is based on the fact that there has been a decline in the value of the asset as a result of failure to make repairs.\textsuperscript{40}

\begin{itemize}
  \item \textsuperscript{38}Moonitz, \textit{op. cit.}, p. 42.
  \item \textsuperscript{40}For an interesting approach to the procedure of showing reserve for repairs as a contra account, see Kenneth B. Berg, "Allowance for Repairs," \textit{The Accounting Review}, (July, 1962), 488-496.
\end{itemize}
Moonitz and Staehling object to this treatment of reserve for repairs as a contra account:

If the liability interpretation is rejected, we are left with the possibility that the "reserve" is a valuation account similar to the allowance for depreciation. But an allowance for depreciation customarily represents an expired portion of the cost (or other basis) of an asset recognized on the books. The reserve for repairs does not represent the cost, expired or otherwise, of any asset reflected in the accounts. ...In short, its use does not fit into the pattern of present day accounting standards, and therefore, should probably not be employed. 41

CHAPTER VI

ACCOUNTING FOR LONG-TERM LIABILITIES

A long-term liability is one which will not be payable within the operating cycle and which will not require the use of current assets for its liquidation. Bonds, mortgages, long-term notes, long-term leases and pension liabilities are items which are usually found in the long-term liability group. There are also other items which have appeared from time to time in various balance sheets as long-term liabilities. It would be virtually impossible to discuss each of these liabilities in detail; therefore, only those liabilities commonly found in the typical balance sheet will be discussed in this chapter.

In Chapter II, it was stated that long-term liabilities should be measured at the present or discounted value of all future payments. These future payments include the amount due at maturity, whether in a lump-sum or in installments, and, in addition, all future interest payments. The yield or effective rate of interest should be used for computing the present value of long-term liabilities. The measurement of the long-term liabilities presented in this chapter will be analyzed and discussed in terms of these principles of liability measurement.
Bonds

When a long-term debt is so large that it is divided up among a number of creditors, as when a corporation is borrowing a large sum from the public, it usually takes the form of a "bond issue,"\(^1\) in which each creditor holds a bond for his share of the debt. There are so many different types of bonds, carrying so many different rights, that a general definition can be stated only in the broadest terms. Arthur Stone Dewing defines a bond as "the instrument representing the contract of the corporation to pay the holder or owner a definite sum of money at a definite time together with periodic payments of interest."\(^2\)

There have been many different types of bonds issued by corporations.\(^3\) These bonds are usually classified according to some characteristic which is deemed to be of cardinal importance. Therefore, the method of classifying bonds into various groups will vary


from writer to writer. One writer, Erwin W. Boehmler, gives the following bond classification scheme:

**Nature of the issuer**—government; municipal; corporate; special revenue; etc.

**Nature of security**—mortgage; collateral trust; debenture; assumed; guaranteed; income; etc.

**Maturity**—long-term; short-term; perpetual; etc.

**Termination** (payment and redemption)—convertible; redeemable; serial; sinking-fund; etc.

**Form of instrument**—coupon; registered.

**Purpose**—refunding; construction; development; equipment; improvement; purchase money; unifying; etc.  

The accounting procedures developed in this section are for bonds with an unqualified right to fixed interest payments on fixed dates and to a repayment of a fixed principal amount on a fixed date. However, these accounting procedures can be easily adapted to other types of bonds.

**Determining the proceeds of a bond issue.** One problem facing the accountant is the determination of the items to be deducted from the selling price of a bond issue in arriving at the proceeds from the issue. It is common practice to deduct legal fees, printing costs,

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underwriting commissions, and other charges associated with the issuance of the bonds from the selling price of the bonds. Paton and Paton contend that such practice is not good accounting. There is a definite distinction, they say, between the cost of raising capital—the amount actually paid for services rendered—and true discount—the excess of maturity value over the amount paid by the original buyer—and such distinction should be recognized in the accounts. Therefore, the various service costs incurred in raising capital are genuine assets and should be dealt with accordingly. Paton and Paton suggest that such costs be amortized over the life of the bond issue on a straight-line basis.

Sometimes it is very difficult to distinguish between the actual amount paid for services rendered and the amount of discount applicable to a particular bond issue. Assume, for example, that an investment group underwrites an issue of X Company bonds amounting to $1,000,000 par value under an agreement that the marketing

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6Ibid.

7Ibid.
of the bonds is entirely under the control of the investment group and that the issuer is to receive a price of 98 points regardless of the terms under which the bonds are distributed. The bonds are sold by the investment group at an average price of 102 and the agreed amount is paid to X Company. Did X Company issue bonds to the investment group at a price of 98, or did the company in effect issue the bonds to various parties at 102, paying the investment group four points for its services? Paton and Paton state that "the amount of discount is determined by the initial decisive transaction; the records of the issuing company are not affected by subsequent transfers from one party to another." In this particular situation, the transaction between X Company and the investment group should be construed as an outright issue of bonds at a price of 98.

In the above example, assume that X Company had been a party to the setting of the distribution price of 102, collected the entire proceeds from the investment group and remitted the amount of four points as a commission to the group. Under these conditions, Paton and Paton contend that the correct treatment would call for recording the bonds at 102 and the recognition of a cost of financial service in the amount of the commission paid to the investment group.

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8Ibid. 9Ibid.
The question arises at this point as to why should bonds be recorded at 98 in one case and 102 in another, when the actual net proceeds from the bond issue is 98 in both cases. Paton and Paton state that:

The only possible way of answering this question is to call attention to the fact that accounting endeavors, to begin with, to report the effects of business transactions, taking place in a legal framework, from the standpoint of a particular enterprise. The costs of the enterprise are the costs actually incurred, not costs as they might have been under other—and perhaps very similar conditions. And costs are not incorrectly recorded because they are not identical with costs of similar factors acquired by other businesses, or by the particular enterprise under other circumstances.\(^\text{10}\)

Another question which may be asked at this point is, "What constitutes the interest cost of borrowing?" Should the effective or yield rate of interest be based on the proceeds of the bond issue after deducting all payments for services including broker's fees, printing costs, \textit{et cetera}, or should the rate be based on the proceeds from the first legal purchaser of the bond issue before deducting service costs?

There is a strong argument for deducting all costs related to the bond issue in arriving at the proceeds. In fact, the bond proceeds computed in this way is the actual amount of funds realized by the company on the sale of the bonds. In a sense, then, the service costs

\(^{10}\text{Ibid.}\)
do constitute a part of the interest cost of borrowing money. Paton and Paton contend, however, that, "The payment for services rendered by investment bankers, like any other commitment, represent one application of the funds received, not a reduction in the amount of such funds." 11

Paton and Paton have presented a very logical and sound argument for the recognition of service costs of a bond issue as an asset to be amortized over the life of the bond issue. This procedure will be adopted and followed in this dissertation.

Recording the bond liability. Assume, for example, that on January 1, 1962, a 20-year, four per cent $1,000,000 bond issue, interest payable annually on January 1, is sold for $875,377.88 to yield five per cent 12 on an annual basis. It is conventional accounting practice to record this transaction in the following manner:

<table>
<thead>
<tr>
<th>1962</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Jan. 1</td>
<td>Cash</td>
<td>875,377.88</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Bond discount</td>
<td>124,622.12</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Bonds payable</td>
<td></td>
<td>1,000,000.00</td>
</tr>
</tbody>
</table>

11 Ibid., p. 225.

The Bonds Payable account is shown in the balance sheet as a long-term liability; however, there is a question as to how bond discount should be presented in the balance sheet. Generally accountants have presented bond discount in the balance sheet under the "Deferred Charge" caption. This practice has been vigorously opposed by a number of accounting writers. For example, W. A. Paton and A. C. Littleton write:

Unaccumulated bond discount cannot express a loss, for there is no dissipation of an asset previously acquired; it cannot express an asset, for no expenditure has been made which would constitute an addition to property in that amount. The inescapable conclusion is that discount on bonds issued is a debit representing prospective interest payable at maturity, and as such should be reported in the balance sheet as a contra to the face or maturity amount of the indebtedness rather than an asset. It is especially unfortunate to apply the expression "prepaid interest" to unaccumulated discount. Far from being prepaid, the discount is unpaid interest, that portion of the total interest which will not be paid until the date the bond is due.

Thus, Paton and Littleton, like many other writers, maintain that bond discount is a liability valuation account rather than a deferred charge. Finney and Miller, on the other hand, say that bond discount is a liability valuation account rather than a deferred charge. Finney and Herbert E. Miller, Principles of Accounting--Intermediate (5th ed.; Englewood Cliffs, New Jersey: Prentice-Hall, Inc., 1958), p. 424.

discount is a deferred charge. They maintain that deferred charges include debits which are ultimately chargeable to operations, and that these debits result from offsetting credits to liability accounts or to cash. Therefore, under this definition of a deferred charge, "bond discount appears to qualify as a true deferred charge." Finney and Miller apparently ignore the fact that "deferred charges" are assets. Therefore, if "deferred charges" are assets, then bond discount must also be an asset if it is considered to be a deferred charge. An asset, as defined in Chapter V, is something which represents future economic benefit or service to the business enterprise. Bond discount does not possess any future economic benefit or service to the enterprise; therefore, bond discount is not an asset.

There is a "practical" objection to showing the bond liability net of the discount. It may be contended that the true legal liability is the face or maturity amount since most bond contracts provide that in the event of default this amount will become immediately payable. Paton and Paton say that, "This point may be met in some


\[16\] Ibid., p. 425.
measure by calling attention to the view, generally accepted, that accounting principles and procedures should be developed primarily from the standpoint of the going concern rather than that of the insolvent or liquidating enterprise.\textsuperscript{17} Furthermore, in the event of insolvency, claims by the bondholders are not, in general, paid in full. Thus, the maturity value may not even reflect the amount which will have to be paid in the event of insolvency.

It has been the practice of accountants to record bond investment at cost; no liability for discount on bonds acquired is ever set up. How one company may acquire an asset--bond discount--without the other company acquiring a liability for bond discount has never been satisfactorily explained. Therefore, if the treatment of bond liability is to be consistent with that of bond investment, then bond discount should be considered as a part of the bond liability account; that is, a contra or liability valuation account.

Bonds may be issued at a premium as well as at a discount. For example, on January 1, 1962, a 20-year, five per cent $1,000,000 bond issue, interest payable annually on January 1, is sold for $1,135,903.25 to yield four per cent. Most accountants would make the following entry to record this transaction:

\footnotesize{\textsuperscript{17}}Paton and Paton, \textit{op. cit.}, p. 223.
The Bonds Payable account is shown in the balance sheet as a long-term liability. The Bond Premium account is often shown under the caption "Deferred Credits" on the liability side of the balance sheet. This procedure may be objected to on the grounds that the bond premium represents a part of the initial liability. Therefore, bond premium, like bond discount, should be considered as a part of the bond liability; that is, it should be added to the maturity value of the bonds in the balance sheet. Also, it might be added, the same arguments for deducting bond discount from the bond payable account applies equally as well to the addition of bond premium to the bond payable account.

In addition to the problem of the presentation of the bond liability in the balance sheet, there is also the problem of the proper amortization of bond discount and premium. Bulletin 43 states that "it is sound accounting procedure to treat such discount (bond discount) as a part of the cost of borrowing to be distributed systematically over the term of the issue and charged in successive annual income accounts of the company." This statement also implies that the

18American Institute of Accountants, Committee on Accounting Concepts, Restatement and Revision of Accounting Research Bulletins,
periodic amortization of bond premium should be considered as a reduction of the bond interest of the period. Today accountants generally follow these procedures for the amortization of bond discount and premium.

Straight-line amortization of bond discount or premium is often followed by accountants. This method, while giving equal periodic amounts of interest, gives unequal rates of interest. A more desirable approach to the amortization problem is to use the "interest method." This method uses the effective or yield rate of interest for determining the amount of the periodic amortization of bond discount or premium. The use of this method results in the presentation of the bond liability (after deducting unamortized discount or adding unamortized premium to the face value of the bonds) on the balance sheet at its present value. Moreover, this amortization method agrees with the principles of liability measurement developed in Chapter II.

There is an alternative method of recording bond liabilities. Under this method, the proceeds of the bond issue are credited directly


to the bond liability account. In the example given earlier, a 20-
year, four per cent, $1,000,000 bond issue, interest payable annually
on January 1, was sold for $875,377.88 to yield five per cent. This
transaction would be recorded as follows:

1962
Jan. 1   Cash                        875,377.88
         Bonds Payable-long-
term                       875,377.88

The following entry would be made on December 31, 1962
(interest is computed at the effective or yield rate of five per cent):

1962
Dec. 31  Interest expense            43,768.89
         Bonds-payable-long-
term                        3,768.89
         Bonds payable-current    40,000.00

The balance in the Bonds Payable-Current account represents
the amount of the bond liability that will be paid currently; that is,
it is the amount of accrued interest on the long-term bond liability
which is currently payable.

The total amount due at maturity is $1,040,000 which con-
sists of $875,377.88, the amount received from the sale of the bonds,
$40,000 of bond interest, at the contract rate for the last interest
period, and $124,622.12, which, in effect, is the amount of interest

Comprehensive Volume (3rd ed.; Cincinnati; South-Western Publish-
due at maturity. Thus, the balance in the Bonds Payable-Long-Term account on December 31, 1962, consists of two parts:

$875,377.88, the amount received from the bondholders, and $3,768.89, the accrued interest to date which is payable at maturity.

The total of the Bonds-Payable-Long-term and Bonds Payable-Current is the present value of the bond liability. Thus, the present value of the bond liability on December 31, 1962, is $919,146.77.

The current portion of the bond liability would be presented in the December 31, 1962, balance sheet as follows:

**CURRENT LIABILITIES**

Bonds payable-current (accrued interest on long-term bond liability currently payable) 40,000.00

The long-term portion of the bond liability would appear in the same balance sheet as follows:

**LONG-TERM LIABILITIES**

Bonds payable-long-term (4%, 20-year, due January 1, 1982, face amount, $1,000,000) 879,146.77

On January 1, 1963, the following entry is made to record the payment of the interest:

<table>
<thead>
<tr>
<th>1963</th>
<th>Bonds payable-current 40,000.00</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jan. 1</td>
<td>Cash 40,000.00</td>
</tr>
</tbody>
</table>
The same procedures can be used to record bonds sold at a premium as was used to record bonds sold at a discount. For example, on January 1, 1962, a 20-year, five per cent $1,000,000 bond issue, interest payable annually on January 1, is sold for $1,135,903.25 to yield four per cent. This transaction is recorded in the following manner:

1962  
Jan. 1  Cash  1,135,903.25  
       Bonds payable-long-term  1,135,903.25

On December 31, 1962, the following adjusting entry is made (interest is computed at the effective or yield interest rate of four per cent):

1962  
Dec. 31 Interest expense  45,436.13  
       Bonds payable-long-term  4,563.87  
       Bonds payable-current  50,000.00

The amount received from the sale of the bonds, $1,135,903.25, consists of two parts: $1,000,000, which is to be repaid at maturity and $135,903.25, which is to be repaid in installments over the life of the bond issue. Therefore, the balance in the Bond-Payable-Long-Term account on December 31, 1962, consists of an amount to be repaid at maturity, $1,000,000, and the amount remaining to be repaid over the remaining life of the bond issue, $131,339.38.

The balance in the Bond Payable-Current is the amount of the
bond liability that will be paid currently. The account is made up of two parts: interest currently payable on the long-term bond liability, $45,436.13, and the current amount due, $4,563.87, of the amount received from the bondholders.

The bond liability account is presented in the balance sheet in a manner similar to that for bonds issued at a discount. The Bond Payable-Current account is shown in the current liability section of the balance sheet while the Bonds Payable-Long-Term account is shown in the long-term liability section. An appropriate parenthetical explanation concerning the nature of these accounts should be included in the statement.

This alternative method of recording the bond liability has several advantages. First, premium and discount on bonds will be completely eliminated from the accounts. Second, accounting for bonds payable is done on a basis consistent with that of accounting for bond investment. Finally, a more correct presentation of bond liabilities will be made, affording pertinent data for full disclosure. Therefore, this method is recommended for recording and reporting bond liabilities.

Refunding of bonds. Bonds frequently contain a provision giving the issuer an option to retire the bonds before maturity. If interest rates have declined, it may be advantageous to the company to float
a new bond issue at a lower rate of interest to obtain funds to pay off the old bond issue. The borrower usually has to pay a premium to the bondholders in order to retire the bonds before maturity.

Since there may be either unamortized discount or premium on the bonds refunded (if conventional accounting procedures are followed), a problem arises as to the proper treatment of such discount or premium. However, this problem disappears if the method of accounting for bond liabilities recommended in the last section is followed since there are no bond discount or premium accounts. There is, however, the problem of what to do with the difference between the amount paid to redeem the bonds and the balance in the Bonds Payable-Long-Term account at retirement date.

There are two methods of accounting for this difference: (1) the transaction with the bondholders may be viewed as definitely closed with the process of retirement; thus, all charges associated with the old bond issue, including the excess of the retirement price over carrying value, should be immediately charged to income or retained earnings; and (2) the process of calling in outstanding bonds and issuing new ones may be viewed as an amendment of the original transaction; therefore, the excess of call price over carrying value together with unamortized issue costs should be considered a part of the cost of issuing the new bonds, and thus spread over either the
remaining life of the old bond issue or the life of the new bond issue.

There are many accounting writers who favor the first method. These writers maintain that the contract with the first group of investors is terminated by the redemption of the bonds at their call price as provided in the old bond agreement. The old bonds are paid in full and cancelled. The new bond issue is separate and distinct from the old bond issue. The bondholders of the old issue may or may not invest in the new issue--the purchasers of the new bond issue may even be an entirely new group. Therefore, since the old bond contract has been terminated, the excess of call price over carrying value as well as unamortized issue costs should be immediately charged to either income or retained earnings.

The American Institute disagrees with the first of the above procedures. Bulletin 43 states:

...the cost of money over the entire period of the original issue is affected by the terms of the original contract, and that if the cost of anticipating maturity is incurred, it is only because it is advantageous to do so; if the saving over the unexpired term of the old bonds will exceed the amount of unamortized discount (equivalent to the difference between face value and carrying value) to be disposed of, such discount should properly be spread over the unexpired term as a proper element of cost of borrowed money. 22

22American Institute of Accountants, op. cit., p. 131.
The Institute's procedure of spreading unamortized bond
discount over the remaining life of the old issue has been challenged
by many writers. For example, Warner H. Hord says that there "is
no more accounting justification for carrying these items (unamor-
tized discount) beyond the retirement of the bonds than for carrying
a depreciation reserve after disposing of the asset to which it
attaches." 23

B. C. Lemke attacks the Institute's position on unamortized
discount on refunded bonds from a different viewpoint. He says:

...the effect then of a deferral of an unamortized discount
and expense applicable to the refunded bond issue is
either to understate the effective liability of the refund-
ing bond issue, or to admit that the act of refunding
can convert a negative liability (he considers bond discount
a liability valuation account) into a positive asset, if the
deferral is shown as an asset in subsequent balance
sheets. 24

These two writers present very logical reasons for not
deferring unamortized discount and expense on refunded bonds to
future periods. Since unamortized discount is analogous to the dif-
fERENCE between the face amount and the carrying value of the bonds

23 Warner H. Hord, "Bond Discount and Debt Expense in Terms
of Consistent Accounting," The Accounting Review, XV (June, 1940),
218.

24 B. C. Lemke, "The Treatment of Un amortized Discount
and Expense Applicable to Bonds Refunded Before Maturity," The
Accounting Review, XXII (October, 1947), 381-382.
at redemption date the same arguments can be used against carrying forward this difference as an asset to be charged against future income as was used against the deferral of unamortized discount. Therefore, the difference between the face amount (or call price where different) and carrying value together with any unamortized issue costs should be charged to income or retained earnings in the period in which the refunding takes place.

Treasury bonds. A company sometimes purchases its own bonds with the expectation of a subsequent sale. These reacquired bonds are usually referred to as "treasury bonds," which some accountants show as an asset in the balance sheet. For example, Norman J. Lenhart and Philip L. Defliese state that, "Treasury bonds held for resale may be shown separately as an investment, at cost."\(^{25}\)

Paton and Paton disagree with this practice. They contend that treasury bonds are not assets, but are a reduction of the outstanding bond liability.\(^{26}\) They feel that treasury bonds are substantially the same as bonds authorized but never issued. Furthermore, the


\(^{26}\)Paton and Paton, op. cit., p. 248.
inclusion of treasury bonds among the assets results in the overstatement of both assets and liabilities. If the bond liability account is to be correctly measured, bonds reacquired by the company, whether for resale or cancellation, should be excluded from the bond liability account.

Paton and Paton say that it is "good practice to avoid the use of a treasury bond account altogether by analyzing the terms of each transaction currently and making entries as indicated in the discussion of the redemption of bonds..." Thus, an entry should be made to record the retirement of the bonds on the purchase date. The amount in the Bonds Payable-Long-Term account applicable to the bonds purchased should be eliminated from this account. Any difference between the redemption price and carrying value may be debited to an expense account or credited to an income account (or debited or credited directly to the retained earnings account). If the bonds are reissued, the reissued bonds should be treated exactly like a new bond issue; that is, the accounting procedures described earlier are to be followed in recording the reissue of bonds. Reacquired bonds may be shown parenthetically or in a footnote to the balance sheet.

Some accountants feel that it is permissible to include

\[\text{Ibid., p. 249.}\]
treasury bonds acquired by a trustee through sinking fund operations among the assets. However, Maurice Moonitz and Charles C. Staehling state that "if... the trustee has bought some of the issuer's own bonds on the market, the debt to that extent has been repaid, because assets of the issuer have been paid out to certain bondholders, and no further diminution in assets will occur with respect to those bonds." Thus, the amount paid for such bonds should be eliminated from the bond liability accounts. In fact, the transaction should be treated as a retirement of bonds through the use of sinking fund assets.

Mortgages and Long-term Notes

Mortgages. A mortgage has been defined as "a lien on land, buildings, machinery, equipment and other property, fixed or movable, given by a borrower to the lender as security for his loan; sometimes called a deed of trust or a defeasible conveyance." The accounting procedures for mortgages are similar to those for bonds. Assume, for example, that X Company on December 31,

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1962, borrows $10,000 from the bank on a four per cent mortgage, with interest payable annually on December 31. The principal is to be repaid in ten annual installments of $1,000 each beginning on December 31, 1963. The following entry would be made to record this transaction:

1962
Dec. 31 Cash 10,000
    Mortgage payable-long-term 10,000

Then, on December 31, 1963, the following entries would be made to record the accrual of interest for the year and the payment of the first installment together with interest:

1963
Dec. 31 Interest expense 400
    Mortgage payable-long-term 1,000
    Mortgage payable-current 1,400

31 Mortgage payable-current 1,400
    Cash 1,400

The mortgage would be presented in the December 31, 1963, balance sheet as follows:

LONG-TERM LIABILITIES

Mortgage payable-long-term
(4%, due in ten-annual installments of $1,000 payable on December 31; 9 installments remaining to be paid) 9,000

In the above example, if the next installment is to be paid within the operating cycle, then it should be shown in the current liability section of the balance sheet. Furthermore, if there is any
accrued interest payable at the balance sheet date, then it should be reported, along with any installment due within the operating cycle, in the current section of the balance sheet.

**Long-term notes.** Long-term notes payable differ very little from bonds payable except for the fact that these notes generally have shorter maturities and are less formal. The discussion regarding the accounting procedures for recording bonds payable is equally applicable to long-term notes. Since this discussion has been previously presented, it will not be presented in this section.

**Long-term purchase contracts.** A company sometimes purchases real estate or other property on the installment plan. If the purchase contract bears a specific rate of interest, then the accounting procedures described for recording mortgages can be used to record the purchase contract.

Occasionally installment purchase contracts are entered into which include no provision for a specific rate of interest. In contracts of this type, interest arises in the form of discount. This discount is the difference between the total of all future installments plus any down payment and the cash price of the asset. The liability for the installment payments should be recorded at their present value—the cash price of the asset less any down payment.

Assume, for example, that X Company purchases an asset on
January 1, 1962, for a down payment of $1,500, and in addition, agrees to pay five annual installments of $1,000 each beginning on January 1, 1963. Furthermore, X Company could have purchased the asset for $6,000 cash. The amount of the discount, under these conditions, is $500 ($5,000 of installment payments plus $1,500 down payment less $6,000 cash price of the asset). The present value of the installment payments is $4,500 ($5,000 of installment payments less $500 discount). The interest rate which will yield a present value of $4,500 for five annual payments of $1,000 was found to be 3.619 per cent--the effective or yield interest rate. The following entries would be made to record this transaction:

1962
Jan. 1   Asset 6,000.00
        Cash       1,500.00
        Installment purchase contract-long-term 4,500.00

The accrual of interest on December 31, 1962 is recorded as follows:

1962
Dec. 31  Installment purchase contract-
        long-term 837.14
        Interest expense 162.86
        Installment purchase contract-
        current 1,000.00

For the payment of the first installment, the following entry is made:

1962
Jan. 1  Installment purchase contract-
        current 1,000.00
        Cash 1,000.00
The Installment Purchase Contract-Long-Term account is shown in the balance sheet as a long-term liability; however, if the next installment payment is to be paid within the operating cycle, then it should be shown as a current liability at the present value of the installment payment. Therefore, in December 31, 1962, balance sheet, the installment purchase contract-current would be shown as a current liability while the Installment Purchase Contract-Long-Term would be shown as a long-term liability.

Long-Term Leases

One of the many problems facing the accountant is the problem of the proper disclosure of long-term leases in the balance sheet. Since future payments under a lease agreement often involve a substantial future outlay of funds, it is of cardinal importance that such agreements be adequately disclosed in the balance sheet in a manner which sets forth all the pertinent facts concerning the lease agreement. There are two methods for presenting long-term leases in the balance sheet: (1) disregard the lease altogether in the financial statements except for a possible footnote and the periodic charge to lease expense; and (2) consider the lease transaction as a financial transaction in which an asset is acquired and a liability is created.

Methods of disclosing long-term leases. Footnote disclosure
has been adopted by most companies for reporting long-term leases.

Perhaps one of the reasons for its adoption by accountants is its endorsement by both the American Institute and the Securities and Exchange Commission. The Institute in Bulletin 43 states:

Accordingly, where the rentals or other obligations under long-term leases are material in circumstances, the Committee is of the opinion that:

(a) disclosure should be made in financial statements or in notes thereto of:

(1) the amount of the annual rental to be paid under such leases with some indication of the period for which they are payable and,

(2) any other important obligation assumed or guaranteed made in connection therewith;

(b) the above information should be given not only in the year in which the transaction originates but also as long thereafter as the amounts involved are material; and

(c) in addition, in the year in which the transaction originates, there should be disclosure of the principal details of any important sale-and-lease transactions. 30

The United States Securities and Exchange Commission's position on long-term leases is almost identical with that of the Institute:

(a) If material in amount the pertinent facts related to firm commitments for the acquisition of permanent investments and fixed assets and for the purchase, repurchase, construction, or rental of assets under long-term leases shall be stated briefly in the balance sheet or in footnotes referred therein.

30American Institute of Accountants, op. cit., p. 126.
(b) When the rentals or obligations under long-term leases are material there shall be shown the amounts of annual rentals under such leases with some indication of the periods for which they are payable, together with any important obligations assumed or guarantee made in connection therewith. If rentals are conditional, state the minimum amounts. 31

The use of a footnote to disclose a long-term lease is objected to by many writers who contend that financial transactions of enormous impact are left out of the accounts in their entirety. For example, John L. Hennessy writes:

...accountants generally agree that footnotes are not a substitute for proper financial statement presentation; footnotes can and should be used, where necessary, to amplify and explain captions and amounts, in the financial statements. In most instances, footnotes relating to long-term lease obligations compel the reader to complete the job which properly belongs to the accountant; they are often ignored, except by financial analysts, and more often than not they are omitted by financial reporting services. 32

The opponents of the use of footnotes for disclosing long-term lease obligations consider the lease transaction as a financial transaction in which an asset is acquired and a liability is created. The question arises, however, as to whether the company has actually


acquired an asset and incurred a liability as the result of signing a long-term lease agreement.

Some writers contend that long-term lease obligations are not like other liabilities. For example, the liability for bonds is significantly different from the liability for future lease payments. Alvin Zises, for example, writes:

Leasing always differs from debt in its economic effect upon the lessee in one or more of the following considerations and such considerations are related to any possible changes in accounting treatment:

(1) Inherently, because of the flexibility inherent in contractual and lease relationships.

(2) Legally, because of the difference in impact in the event of the lessee being in financial difficulty.

(3) Financially, because leasing may make an extra contribution to earnings as a result of special considerations.

(4) Tax wise, because under certain circumstances leasing may reduce tax burden.

(5) Operationally, because of economies in operations performed for the lessee by the lessor. 33

Zises does not appear to have a clear understanding as to what constitutes a liability for accounting purposes. According to the definition of liabilities developed in Chapter II, future lease payments

do qualify as liabilities.

A long-term lease is an obligation of the lessee. The lessee has a duty to deliver assets to someone outside of the business enterprise. There is also a claim against the lessee by the lessor which will require settlement in the future. This settlement will require a future outlay of funds whose amount is generally obtainable from the terms of the lease contract. Furthermore, the long-term lease is a result of a past or current transaction—the signing of the lease contract. Since future lease payments have all the characteristics of liabilities, then it is apparent that they should be recorded in the accounts as liabilities.

If the lessee's liability for future lease payments is recorded in the accounts, then an offsetting amount must be recorded in an asset account. Some accountants object to the capitalization of the future lease payments on grounds that the leased property does not legally belong to the lessee. Thus, to these accountants, legal ownership of property is a necessary requirement before such property can be included as an asset in the balance sheet. If this requirement for the recognition of an asset in the accounts was strictly followed by accountants, several items which now appear in balance sheets would have to be deleted. For example, few, if any, accountants would object to showing leasehold improvements in the balance sheet as an
asset even though such improvements are not the property of the lessee.

Assets, as defined in Chapter V, represent future economic benefits or services to the business enterprise. A lease would certainly qualify under this definition since the lessee is going to receive future benefits from the use of the property. The lessee has acquired an asset in the form of a right to use property, not the property itself. There are several writers who agree with this interpretation, of a lease contract. For example, John H. Myers says that, "The asset, right to use leased property, is truly an asset even though not owned." 34

Measurement of liability and asset values of a long-term lease.

Now that the problem of whether or not a lease transaction results in a liability and an asset has been settled, the next problem is the proper measurement of the liability and related asset. The liability should be measured at the present value of all future rental payments required under the terms of the lease.

The computation of the present value of the future rental payments involves the section of a proper interest rate. Albert H. Cohen points out that the interest rate can often be determined from the lease agreement:

34John H. Myers, Reporting of Leases in Financial Statements
In most actual cases of long-term leases, ..., the negotiations between the parties which precedes the execution of the lease will reveal the interest and compounding frequency which is implicit in the final agreement. When the property was constructed by the business enterprise securing financing under an agreement whereby the lessor would purchase it at cost, the lessee would have direct knowledge of the cost valuation established for the property.  

Therefore, the interest rate to be used in discounting future lease payments is that used in setting the rentals. Where the interest rate cannot be readily determined from the lease transaction, Myers suggests the following solution:

...(a) the prime rate adjusted for the company's creditworthiness, (b) the rate the company is paying for loans recently negotiated, plus 1/2 to 1 percentage point because of the lease, or (c) the price on the bond market of similar credit (again raised a point or less because the instrument is a lease rather than conventional debt)."  

The amount to be assigned to the asset (right to use property) is the present value of all future lease payments. This is, in effect,  

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36Myers, op. cit., p. 46.
the "cost" of the asset since the lessee is required to pay this amount together with interest (interest is, of course, a part of each rental installment) to the lessor for the use of property during the term of the lease.

**Accounting for the lease liability.** Assume, for example, that on January 1, 1962, X Company enters into a lease agreement with Z Company for rental of a building. The agreement calls for X Company to pay Z Company $10,000 a year for 30 years (the expected life of the building) beginning on January 1, 1963. X Company also agrees to pay all taxes, insurance, and maintenance costs associated with the building. The effective rate of interest to be used in computing the present value of future rental payments is 7 per cent (the present value of future rental payments is approximately equal to the market value of the building).

The following entry would be made to record this transaction:

1962
Jan. 1 Rights to leased property 124,090.41
Liability under lease contract 124,090.41

The accrual for interest on December 31, 1962 is recorded as follows:

1962
Dec. 31 Interest expense 8,686.33
Liability under lease contract 8,686.33
The first payment made on January 1, 1963, is recorded as follows:

1962
Jan. 1 Liability under lease contract 10,000
Cash 10,000

The Liability under Lease Contract account is shown in the long-term liability section of the balance sheet along with an appropriate explanation of the terms of the lease agreement. In addition, any installments due within the operating cycle are classified as current liabilities. The account "Rights to Leased Property" appears in the balance sheet as a fixed or long-term asset.

The asset (right to leased property) may be amortized for the same reasons that apply to other assets of limited life. Myers says that, "Amortization schedules for rights to leased assets would be chosen in the same manner as are depreciation schedules for other items of property, plant, and equipment." 37 Thus, a company may use straight-line, declining balance, sum-of-years-digits, or any other method that is suitable for the type of property leased by it.

When to capitalize a lease. One of the problems in accounting

37Ibid., p. 48. Some writers contend that the constant yield method of amortization should be used to amortize the asset (rights to leased property). For example, see Shillinglaw, op. cit., pp. 586-587; or Moonitz and Staehling, op. cit., pp. 315-316.
for long-term leases is that of determining when to capitalize a particular lease. Myers suggests the following practical solution to this problem:

The entire amount of rentals is probably a payment for property rights in the case of a lease containing all of the following provisions:

1. **Length**—The lease covers substantially all the entire useful life of the leased property.

2. **Options at termination**—The lessee may buy the property at the termination of the lease at a nominal price.

3. **Cancellation provisions**—The contract is non-cancellable.

4. **Rent**—The lessee pays a fixed amount (as distinguished from variable) sufficient to return to the lessor his investment in the property under lease plus a fair return.

5. **Taxes, insurance, maintenance**—These and other similar costs are paid by the lessee.

On the other hand, only a trifling portion of the rentals would constitute payment for the property rights in a case such as the following:

1. **Length**—The lease covers a very short period of time.

2. **Options at termination**—The lessee has no option at termination specifically open to him under the contract.

3. **Cancellation provisions**—The contract may or may not contain a provision for cancellation.
4. Rent--The lease provides that rents shall be set at a level which is competitive with rents of comparable property and service.

5. Taxes, insurance, maintenance--These and similar items are to be paid by lessor.

6. Other services--These are to be supplied by the lessor.

In this case, payment of maintenance cost, insurance, taxes, and the other services by the lessor would clearly constitute a major portion of the rentals.38

Pension Plans

A pension plan has been defined, for accounting purposes, to "mean a formal arrangement for employee retirement benefits, whether established unilaterally or through negotiations, by which commitments, specific or implicit, have been made which can be used as a basis for estimating costs."39

There are, in general, two types of pension plans: nonfunded and funded. Under the nonfunded plans, the employer adopts a plan under which a pension might be granted, but no provision is made to fund the benefits. This type of plan is known as the "pay-as-you-go"

38 Myers, op. cit., pp. 4-5.

or "out-of-pocket" plan. Upon retirement, the employees are transferred from an active worker's payroll to a pensioner's role. Since no special fund has been set up by the company, the pension payments are paid out of the general funds of the company.

Funded pension plans may be self-administered by the company through a trustee or may be turned over to an insurance company to be administered. The employer may pay the entire cost of the pensions (noncontributory plan) or the employee may share in the cost (joint-contributory plan). The necessary contributions called for by the plan are computed by actuarial techniques and deposited with the trustee or insurance company. The pensions, then, are paid out of the fund deposited with the trustee or insurance company.

There are two major problems involved in determining the liability for pension plans: (1) liability for past services and (2) liability for current services.

Liability for past services. The problem of accounting for the past services may be approached in the following ways: (1) the liability is immediately recognizable to the extent of the accrued claims of employees on account of services already rendered; and (2) the liability arising under a pension agreement for past services is accrued during the years following the date of the agreement.

The first approach involves the recognition of the liability at
the time the plan becomes operative. This "liability" has all the characteristics associated with liabilities. The company has an obligation to pay out funds in the future to its employees upon their retirement. This future outlay of funds can be determined with some degree of accuracy through the use of actuarial techniques. In addition, the obligation to pay pensions based on past services is the result of a past transaction.

Since the future outlay of funds for pensions resulting from past services is a liability, the problem is now one of what to do with the debit part of the transaction. There are three possible solutions to this problem: (1) charge retained earnings with the past service costs; (2) charge revenue in the year the plan is adopted with the past service costs; or (3) carry forward the past service costs as an asset which will be amortized according to some logical amortization scheme.

Some accountants favor the first method, that of charging retained earnings with the full estimated cost upon adoption of the plan. These accountants hold that past service costs are applicable to periods prior to the date of the adoption of the plan, that the total amount is a liability immediately upon adoption of the plan, and that it should, therefore, be charged to retained earnings as of the date of adoption. 40

40 Rufus Wixon (ed.), Accountant's Handbook (4th ed.; New York:
There are several objections to this method. These objections are usually based on the assumption that the past service costs are incurred in contemplation of present and future services, and, therefore, should not be charged to retained earnings. 41

The second method, that of charging past service costs against revenue in the year of adoption of the plan, is subject to the same argument given above against the first method.

The third and most widely accepted method is that of charging past service costs against revenue over a period of years according to some logical scheme of amortization. The carrying forward of these costs as an asset is based on the assumption that such costs will result in future economic benefits to the company in the form of "better employee morale, the removal of superannuated employees from the payroll, and the attraction and retention of more desirable personnel..." 42 Therefore, if an asset is thought of as possessing future economic benefits or services, then past service costs certainly qualify as an asset. The most logical method for amortization

41 This is essentially the viewpoint taken by the American Institute, see American Institute of Accountants, Bulletin 43, pp. 117-118; and American Institute of Accountants, Bulletin 47, p. 14.

42 American Institute of Accountants, Bulletin 43, p. 117.
of past service costs is to charge the costs against revenue in equal installments over the average remaining working lives of the eligible employees. 43

Another method of accounting for the liability for past service costs is that of accruing the liability during the years following the date of the adoption of the plan. Thus, the liability account is increased each accounting period as the past service costs are accrued and charged to income. This method may be objected to on the grounds that the entire amount of liability should be recognized in the accounts as soon as a pension plan becomes operative. The liability for past service costs do not "accrue"; the company owes its employees the entire amount of the pension based on past service costs—they do not have to perform any additional services in the future to merit such pensions (except, in some cases, to remain in the employment of the company).

Paton and Paton object to the recognition of the full amount of the liability for past services costs in the accounts. They point out

that "the use of footnotes which gives the essential facts is to be preferred to a treatment which has the effect of padding both sides of the balance sheet." The use of a footnote is not a very good substitute for the accounting procedure of recognizing the past service costs liability in the balance sheet. Even though the recognition of a liability along with a related asset might be thought of as "padding" both sides of the balance sheet, the fact remains that the company has incurred a liability for future payment of pensions based on past service costs, and this liability as well as the related asset should be recognized in the accounts.

**Liability for current services.** The liability for current services should be related, as nearly as practical, to the services of the employees on which the pensions are based. This involves a credit to a liability account and a debit to an expense account for the full current costs of the pensions, based on the services rendered by the employees covered by the plan during the accounting period.

This method **immediately** recognizes the liability for future pension payments as services on which the pensions are based are rendered.

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45 Dean calls this method of accounting for the current costs of pension plans the "provision method." Dean, *op. cit.*, pp. 104-105.
performed by the employees. Thus, it is consistent with the procedure of immediately recognizing in the accounts the liability for the future payment of pensions based on past services. Both the liability for past and current services are, in effect, based on "past services" since the employees performed such services prior to the balance sheet date.

Measuring the pension liability. Pension liabilities, like other long-term liabilities, should be measured at their present value. The computation of the present value requires the use of actuarial techniques. The determination of the liability under most pension plans is a highly technical process and, in most cases, requires the services of a person trained in actuarial techniques. For this reason, then, the computation of the amount of pension liabilities will be omitted from this dissertation. 46

If a pension plan is fully funded with an insurance company, then the pension liability is discharged upon payment of the premium. The payment of future pensions then become the liability of the insurance company. However, an accrual of a liability may be in order

where the premium payment is to be made after balance sheet date and such premium is based on services performed during the current accounting period.

There is a question as to whether the liability along with the asset (pension fund) should be shown in the balance sheet where deposits are made to a trustee under an irrevocable trust agreement. This problem is not peculiar to a pension plan—it exists also in a bond sinking fund. Paton makes the following comments on this subject:

The argument for the treatment of a bond sinking fund as an asset, to the extent of the amount not used to acquire outstanding bonds, runs somewhat as follows. The fund may be entirely outside of the control of the depositing company, and dedicated irrevocably by the contract to the specific purpose of retiring obligations, but until actually used to retire bonds, there is no reduction in the full amount. The bonds are a genuine liability until actually acquired by the trustee; merely effecting arrangements to pay does not constitute retirement. If the trustee defaulted or otherwise failed to make good his obligation to retire bonds through funds placed at his disposal for this purpose, the bonds would still be outstanding and would be a legitimate obligation of the issuing company. 47

On the basis of the reasoning given above by Paton, it would seem that the question of whether or not the pension fund along with

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the related liability should be shown in the balance sheet is a purely legal consideration. If the liability for future pension payments has been legally discharged by pension payments into an irrevocable trust fund, then the pension fund and related liability should not be shown in the balance sheet. However, in cases where a legal liability still exists after payment into a trust fund, the fund should be shown as an asset with the related pension liability account being shown as a liability.

In the case of unfunded pension plans, the liability for both services performed prior to adoption of the plan and services performed after adoption of the plan should be shown in the balance sheet. This procedure has been objected to by many accountants on the grounds that the amount of the liability is often very difficult to estimate. It is contended that such an estimation is very difficult because of the many variable or unknown factors affecting the computations. Some of these variable or unknown factors are changes in the level of wages, changes in the amount of social security benefits, inclusion of total disability coverage, employee turnover, ages at which actual retirement takes place, average rate of mortality before and after retirement, average rate of earnings on pension fund, and so on. 48

48Dean, op. cit., p. 104.
The determination of the pension liability under most plans would probably be difficult, but not impossible. Assumptions can be made regarding the variable or unknown factors which affect the computation of the liability. There is nothing unusual about accountants making assumptions; for example, the accountant is always making an assumption in regard to the expected useful life of an asset.

The American Institute in *Bulletin 47* expresses the same viewpoint:

Because of these factors, the total cost of the pensions that will be paid ultimately to the present participants in a plan cannot be determined precisely in advance, but, by the use of actuarial techniques, reasonable accurate estimates can be made. There are other business costs for which it is necessary to make periodic provisions in the accounts based upon assumptions and estimates. The Committee believes that the uncertainties relating to the determination of pension costs are not so pronounced as to preclude similar treatment.\(^49\)

If a pension plan is partially funded with an insurance company, then the pension liability would be reduced by the payment of premiums to the company. In the case of a partially funded plan involving an irrevocable trust fund, if the deposit made to the trustee legally discharged part of the company liability for future payments of

pensions, then the payment would reduce the liability by the amount paid to the trustee. If, however, the company remained liable for the full amount of the pension liability after the deposit was made, then the liability would not be reduced by payments into a fund and furthermore, the pension fund itself would be shown as an asset in the balance sheet.

Other Long-Term Liabilities

Long-term advances from customers. The term "advances from customers" applies to liabilities which arise from the receipt of payments in advance of furnishing the services or delivery of the product for which funds are received. In most cases, advances from customers are classified as current liabilities, since the service will be performed or the product delivered within the operating cycle. Sometimes, however, payments are received in advance which require services to be performed or products to be delivered over a period of time which is longer than the operating cycle. Such long-term collections should be presented in the balance sheet as long-term liabilities.

The normal accounting procedure is to record the amount of the advance payment as a liability. For example, on January 1, 1962, X Company receives $4,100.20 from Z Company as an advance
payment for the use of a building for five years. The following entry is usually made to record this transaction:

1962
Jan. 1  Cash  4,100.20
          Rent received in advance  4,100.20

Then on December 31, 1962, the following entry is made to record that portion of the rent earned in 1962:

1962
Dec. 31  Rent received in advance  820.04
          Rent revenue  820.04

The Accountant's Handbook objects to this method of recording rent revenue for 1962:

The total down payment in lieu of annual rentals represents the initial liability on the lessor's books. Subsequently, this amount is amortized on either a straight-line or compound interest method by debiting the liability account and crediting a revenue account. If implicit interest is ignored, the credits to revenue will be less than the full rental value of the property. On the other hand, recognition of implicit interest will permit a credit to revenue equal to the full rental value. 50

In the above example, assume that X Company could have rented the building to Z Company for $1,000 a year if rent is paid annually. Under these circumstances, the Accountant's Handbook would contend that the credit to revenue should be $1,000 instead of $820.04.

50 Wixon, op. cit., p. 20-36.
Therefore, there is an implicit interest factor involved in the recognition of revenue for the year. Using an implicit interest rate of seven per cent, the following entries would be made to record the annual rent revenue for the five year period:

<table>
<thead>
<tr>
<th>Year</th>
<th>Date</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1962</td>
<td>Dec. 31</td>
<td>Implicit interest expense</td>
<td>287.01</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Rent received in advance</td>
<td>712.49</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Rent revenue</td>
<td>1,000.00</td>
</tr>
<tr>
<td>1963</td>
<td>Dec. 31</td>
<td>Implicit interest expense</td>
<td>237.10</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Rent received in advance</td>
<td>762.90</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Rent revenue</td>
<td>1,000.00</td>
</tr>
<tr>
<td>1964</td>
<td>Dec. 31</td>
<td>Implicit interest expense</td>
<td>183.70</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Rent received in advance</td>
<td>762.90</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Rent revenue</td>
<td>1,000.00</td>
</tr>
<tr>
<td>1965</td>
<td>Dec. 31</td>
<td>Implicit interest expense</td>
<td>126.56</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Rent received in advance</td>
<td>873.44</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Rent revenue</td>
<td>1,000.00</td>
</tr>
<tr>
<td>1966</td>
<td>Dec. 31</td>
<td>Implicit interest expense</td>
<td>65.43</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Rent received in advance</td>
<td>934.57</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Rent revenue</td>
<td>1,000.00</td>
</tr>
</tbody>
</table>

One of the advantages of the above procedure is that it results in the measurement of the liability for advances from customers at its present value. In this example, the initial liability is $4,100.20.

51 The implicit interest rate is computed by finding the rate which will yield a present value of $4,100.20 (the amount received from Z Company) for five annual payments of $1,000 each.
the amount received from Z company—which is the discounted value of the full rental value of the property; that is, the present value of five, $1,000 annual rental payments which could have been received if the building was rented on an annual basis.

Since the compound interest method was used for amortizing the amount in the Rent Received in Advance account, the balance in this account represents the present value of the liability for future services to be rendered by the company.

There are several types of business enterprises which receive long-term advance payments from customers. Although there is always an implicit interest factor inherent in any advance from a customer, it is often difficult to isolate this factor from other implicit cost factors. For example, a magazine publishing company offers the following subscription terms:

$10 for one year (paid in advance)
$21 for three years (paid in advance)

Under these terms, the implicit discount rate on an advance payment by a subscriber for a three-year subscription is 20.2 percent. Since this rate is too high to be strictly an interest rate, there must be other implicit costs involved in the discount rate. Such implicit costs may result from the reduction of certain costs by granting a three-year subscription instead of a one-year subscription.

In the above example, assume that a three-year subscription
was taken out on January 1, 1962, and, in addition, that the implicit interest rate is six per cent. Under these conditions, the following entries would be made:

1962
Jan. 1  Cash                  21.00  
        Subscriptions received in advance 21.00
        To record receipt of payment
        for a three-year subscription

Dec. 31 Implicit interest expense 1.26
        Implicit subscription expense 2.14
        Subscriptions received in advance 6.60
        Subscription revenue 10.00
        To record the subscription revenue for the year together
        with implicit interest and subscription expense

1963
Dec. 31  Implicit interest expense .86
        Implicit subscription expense 2.14
        Subscriptions received in advance 7.00
        Subscription revenue 10.00
        To record the subscription revenue for the year together
        with implicit interest and subscription expense

1964
Dec. 31  Implicit interest expense .46
        Implicit subscription expense 2.14
        Subscriptions received in advance 7.40
        Subscription revenue 10.00
        To record the subscription revenue for the year together
        with implicit interest and subscription expense

The above accounting procedures result in the measurement of the Subscriptions Received in Advance account at its present value.
However, this procedure may be objectionable for two reasons: (1) it may be difficult to select an appropriate implicit interest rate; and (2) the inclusion of implicit costs in the financial statements does not follow the cost basis of accounting.

The first objection may be overcome by using the prevailing market interest rate. The second objection, however, cannot be set aside quite as easily. Cost is usually defined as a payment, in cash or other assets, or the incurring of an obligation to make a future payment, for an economic benefit received or to be received. There has been no actual outlay of funds nor has an obligation been incurred in connection with these implicit costs. Thus, it would seem that these costs should be omitted from the accounts.

If, however, advances from customers is considered to be a "loan" by the customers to the company, then there is a sound basis for inclusion of implicit interest costs in the accounts. The "loan", in this case, is to be paid back to the customers in the form of the performance of service or delivery of product rather than in the form of cash or similar assets. Just as there is interest expense in connection with a non-interest bearing note discounted at the bank, there

\[52\] The problem of the selection of an implicit interest rate is similar to that of selecting an interest rate for capitalizing long-term leases. See pp.144-145 for a discussion of the problem of selecting interest rates for long-term leases.
is also interest expense in connection with advances from customers.

In the case of a non-interest bearing note, interest arises because the amount to be paid back to the bank is greater than the original amount received from the bank. In the case of advances from customers, interest arises because the value of the services to be rendered to the customer is greater than the value of the advance payment received from the customer. Thus, implicit interest associated with an advance from customer is just as much an expense as interest on a non-interest bearing note discounted at the bank.

The argument for considering implicit costs other than implicit interest as being similar to other costs is not as strong. These implicit costs, are, in effect, a "saving" in future costs because an advance payment was received from customers rather than payment by customers as services were performed. Therefore, the best accounting procedure would seem to be to ignore such costs in the determination of the periodic revenue resulting from the advance payments by customers. It must be pointed out, however, that implicit interest costs are not "savings" in future costs, but are interest costs associated with a "loan" in the form of advances from customers.

Referring to the previous example, the following entries should be made to record the annual subscription revenue together with implicit interest expense:
<table>
<thead>
<tr>
<th>Year</th>
<th>Date</th>
<th>Account Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1962</td>
<td>Dec. 31</td>
<td>Implicit interest expense</td>
<td>1.26</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Subscriptions received in advance</td>
<td>6.60</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Subscription revenue</td>
<td>7.86</td>
</tr>
<tr>
<td>1963</td>
<td>Dec. 31</td>
<td>Implicit interest expense</td>
<td>0.86</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Subscriptions received in advance</td>
<td>7.00</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Subscription revenue</td>
<td>7.86</td>
</tr>
<tr>
<td>1964</td>
<td>Dec. 31</td>
<td>Implicit interest expense</td>
<td>0.46</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Subscriptions received in advance</td>
<td>7.40</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Subscription revenue</td>
<td>7.86</td>
</tr>
</tbody>
</table>

Long-term advances from customers, as pointed out earlier, should be shown in the balance sheet as long-term liabilities. If any part of the service is to be performed or any of the product delivered within the operating cycle, the amount of the liability which will be discharged in the next operating cycle is classified as a current liability.

The use of the compound interest method of amortization results in the measurement of the liability for advances from customers at its present value. This method may be used even though no interest expense is recognized in the accounts. For example, the annual amortization of the Subscriptions Received in Advance account in the example cited previously would be recorded as follows (assuming a six per cent interest rate).

<table>
<thead>
<tr>
<th>Year</th>
<th>Date</th>
<th>Account Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1962</td>
<td>Dec. 31</td>
<td>Subscriptions received in advance</td>
<td>6.60</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Subscription revenue</td>
<td>6.60</td>
</tr>
</tbody>
</table>
1963
Dec. 31 Subscriptions received in advance  7.00
  Subscription revenue  7.00

1964
Dec. 31 Subscriptions received in advance  7.40
  Subscription revenue  7.40

In any event, the compound interest method for amortizing
advances from customers should be used regardless of whether interest
expense is recognized in the accounts.

Reserve for self-insurance. Self-insurance has been described
as "a plan by which a company assumes either the partial or full risk
of some possible future events which would result in a reduction of
the company's assets instead of insuring the risk with a private
agent."

A "reserve for self-insurance" may be created through a
periodic charge to income. Frequently, a "reserve for self-insur-
ance" created in this manner is classified as a liability in the balance
sheet. This "reserve" account is not a liability since it does not have
any of the characteristics of a liability.

A "reserve for self-insurance" is not an obligation of the
firm. For an obligation to exist, there must be claims by outside

53 Horace Brock, "Accounting for Self-Insurance Against Fire
Loss--Theory v. Practice," The Accounting Review, XXXIV (April,
1959), 257.
creditors against the firm. In this case, there are no claims by outside creditors, and in fact, the destruction of the property will probably not even result in a claim against the company. However, the destruction of the asset may result in a decision to incur a liability to replace it, but this type of obligation is just as likely to be undertaken regardless of whether the asset wears out, burns down, becomes obsolete, spoils, or is sold to customers. Most accountants would not recognize these obligations until they are actually incurred by the company.

For a liability to be present, the company must have a duty to deliver assets in the future to someone outside of the business enterprise. Since there are no claims by outsiders against the company for failure to insure an asset, then a "reserve for self-insurance" does not require a future payment of assets.

A "reserve for self-insurance" is not the result of a past transaction. It represents a future transaction—the destruction of the asset—which may not even take place. Thus, it is concluded that a "reserve for self-insurance" should not be presented in the balance sheet as a liability.

There are several other methods for presenting a "reserve for

self-insurance" in the balance sheet. Bernard Magruder suggests that a debit be made to an expense account and a credit to a contra-asset account for the periodic self-insurance charge on the basis that self-insurance against fire loss is an element similar to depreciation. This argument seems to imply that every asset has an inherent inflammable nature and that this potential should be recognized in the allocation of the cost of the asset over its useful life. Paton and Paton point out that a "casualty does not accrue." Casualty losses are always a possibility, but they are not inevitable.

Another method of accounting for self-insurance is to create a reserve by charges against retained earnings. Paton and Paton argue strongly for this procedure:

The inescapable conclusion is that a "reserve" for a casualty loss that has not taken place is nothing more nor less than a slice of the existing stockholders' equity, and that it is improper to set up such a reserve by charges to revenue. If it is desired to suggest the exposure to risk by accounting classification the only acceptable procedure is the earmarking of retained earnings.


56 Brock, op. cit., p. 358.

57 Paton and Paton, op. cit., p. 143.

58 Ibid., pp. 144-145.
It has been stated that a "mere bookkeeping entry setting aside a reserve for insurance out of surplus is an illusion." Brock points out that the "primary purpose of earmarking or appropriating retained earnings is to restrict dividend payments to stockholders." If this restriction, Brock contends, results in an improvement in a company's working capital, the entry is more than an "illusion."

Another method for disclosure of a self-insurance program is the use of a footnote. This method may even be more informative than a subdivision in the balance sheet.


60 Brock, op. cit., p. 259.
CHAPTER VII

ACCOUNTING FOR CONTINGENT LIABILITIES

Montgomery's Auditing defines a contingent liability in the following manner:

The term "contingent liability" should be used in the accounting sense to designate a possible liability of presently determinable or indeterminable amount which arises from past circumstances or actions, which may or may not become a legal obligation in the future, and which, if paid, gives rise to a loss or expense or an asset of doubtful value.¹

The American Institute in Bulletin 50 gives a similar definition:

In accounting a contingency is an existing condition, situation or set of circumstances, involving a considerable degree of uncertainty, which may, through a related future event, result in the acquisition or loss of an asset, or the incurrence or avoidance of a liability, usually with the concurrence of a gain or loss.²

These two definitions indicate that a contingent liability has three characteristics: (1) it is the result of a past event; (2) it depends on some future event taking place before it becomes an actual liability; and (3) the amount of the contingent liability may or may not be known.


²American Institute of Certified Public Accountants, Committee
A contingent liability is the result of some event which has taken place prior to the date of the balance sheet. This event involves some sort of relationship between the business enterprise and an outside person or entity. This past event is the result of some direct or indirect act the company performed (or perhaps failed to perform) which affected an outside person or entity.

In addition to existing as a result of a past event, a contingent liability, through a related future event, may or may not result in the company incurring an actual liability. This future event involves the performance or nonperformance of an act by someone outside of the business enterprise. As a result of the action taken by that person, the contingent liability may become an actual liability, or the contingent liability may be eliminated completely with no actual liability being incurred. Until this future event has transpired, the contingency element exists and the ultimate disposition of the contingent liability remains uncertain.

Perhaps an illustration will help to further clarify the above discussion. For example, a note receivable discounted at the bank is a contingent liability since it is the result of a past event (the discounting of the note), and its final disposition depends on a future

event (the payment or nonpayment of the note by its maker) taking place. In event the maker of the note pays the bank, the company which discounted the note will no longer have a contingent liability. Thus, the performance of an act (payment of the note) by an outside person (the maker of the note) will eliminate the contingent liability. However, if the maker of the note fails to pay the bank, the company who discounted the note will have incurred an actual liability. This actual liability results from an action (failure to pay the note) taken by an outside person (the maker of the note).

The amount of a contingent liability may or may not be known. Some common contingent liabilities whose amounts can be determined are the sale, pledge, or assignment of accounts receivable when the transfer attaches a liability to the seller in the event of noncollection; discounting notes receivable; accommodation endorsement of notes; and guarantee of payment of interest and/or principal on bonds of another person. There are a number of contingent liabilities whose amounts cannot be precisely determined. Among the more common of these contingent liabilities are matters in litigation, such as alleged patent, copyright, and trademark infringements; proposed additional taxes for prior periods, which the company believes are unwarranted; and possible claims by employees for back compensation under laws, the interpretation of which is uncertain. Although the amounts of
these contingent liabilities cannot be accurately determined, they
should still be disclosed in the financial statements. In most cases,
an estimate can be made of the amount of the contingent liability.

Losses which may take place in the future frequently appear
in financial statements as contingent liabilities. There is no objec-
tion to this procedure as long as such contingent losses are the result
of past events and the company will incur liabilities if the losses
do occur. For example, if a building burns down, the company suffers
a loss; it does not incur a liability. Therefore, future losses of this
type should not be shown in the balance sheet as contingent liabilities.

Lenhart and Defliese agree with this viewpoint when they say:

Losses which may arise from possible future events are
sometimes wrongly referred to as contingent liabilities.
For example, the possibility that property may be
damaged by tornadoes in certain sections of the country
does not create a contingent liability and requires no
recognition in the financial statements. 3

Disclosure of Contingent Liabilities

There are several methods of presenting contingent liabilities
in the financial statements: (1) creating a reserve account by appro-
priation of retained earnings; (2) recording the asset at gross and
deducting the contingent liability; (3) showing both the contingent

3Lenhart and Defliese, loc. cit.
liability and related contingent asset in the balance sheet; (4) showing the contingent liability under a separate balance sheet heading; and (5) using a footnote to disclose the contingent liability.

Reserve for contingencies. A contingent liability may be disclosed in the balance sheet in the form of a reserve for contingencies account. This account is created by a debit to retained earnings and a credit to a reserve account. For example, a company becomes involved in a patent infringement lawsuit, and there is some doubt as to the outcome of the lawsuit. Under these circumstances, the amount of the contingent liability may be liberally estimated after the accountant has conferred with the company's attorneys, and an entry such as the following is made to acknowledge the contingency:

\[
\begin{align*}
\text{Retained earnings} & \quad \text{XXX} \\
\text{Reserve for a liability} & \quad \text{under a judgment} \quad \text{XXX}
\end{align*}
\]

Arthur Rosenkampff and William Wider point out that this entry by no means concedes the liability, but it does provide for the contingency that has arisen.\footnote{Arthur H. Rosenkampff and William Wider, \textit{Theory of Accounts} (New York: The Ronald Press Company, 1942), pp. 320-321.} This reserve account is shown as an appropriation of retained earnings in the balance sheet.\footnote{American Institute of Accountants, Committee on Accounting Procedures, \textit{Review and Restatement of Accounting Research Bulletins}, No. 43. (New York: American Institute of Accountants, 1953), p. 43.
When the lawsuit has been settled, the amount in the reserve account should be restored directly to retained earnings. If the lawsuit is lost by the company, an actual liability has been incurred and should be recognized in the accounts by a debit to a loss account and a credit to a liability account.

There are several objections that have been voiced by writers against the use of reserves as a means of disclosing contingent liabilities. For example, W. A. Paton and W. A. Paton, Jr. write:

Subdividing retained earnings, it should not be forgotten, neither provides a fund of cash nor strengthens the capital structure. The entire stockholders' equity is of course the first line of defense against losses--the underlying cushion for the risks encountered in business operations--but labeling this total equity as a "reserve for possible losses" would not be particularly helpful and the merit of so labeling a portion of the total is not so obvious.

Carmen Blough reaches the same conclusion as Paton and Paton:

If a reserve for contingencies has a useful function, it is an earmarking or appropriation of earned surplus, to provide a partial explanation of the dividend policy and a systematic method of administering the undistributed earnings. We doubt, however, whether the amounts involved will often justify the use of a special account for this purpose. The entire balance of retained earnings is, in effect, a reserve for contingencies, and a footnote

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6 Ibid.

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6 Ibid.

explanation will serve equally well, if not better, to make the situation clear to the reader. We believe that the term "reserve" in this connection is often misinterpreted and it is assumed to represent funds set aside to meet contingencies when they arise, but of course it represents nothing of the sort.\(^8\)

The American Accounting Association points out that the use of reserves often confuses the financial statement reader:

Type (c) appropriations to "provide" for anticipated or conjectural losses, may be intended to disclose hazards the effect of which cannot be objectively determined. Such hazards are numerous in most business enterprises and "provisions" are established on a highly selective basis. Appropriations encountered in current practice vary so widely in purpose and scope, and carry such uniformative captions, that a reader of published statements who is not able to secure additional information is confused and frequently misled.\(^9\)

According to the above viewpoints, appropriations of retained earnings are not an effective means of disclosure of contingent liabilities. This same viewpoint will be adopted in this dissertation.

**Recording the asset at gross and deducting the contingent liability.** Almost every business enterprise has what are known as

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"contingent assets" as well as related contingent liabilities. Thus, if a contingent liability becomes an actual liability, then the related contingent asset becomes a real asset. The best example of a contingent asset and contingent liability is a note receivable discounted at the bank. If the note is dishonored by the maker, then the company who discounted the note becomes liable for its payment. Also the company acquires an asset in the form of a receivable since the company has the right to collect from the person who dishonored the note.

When a contingent liability involves a related contingent asset, the amount of the contingent asset can be included in an asset account with the related contingent liability as a contra account. For example, in the case of a note receivable discounted, the contingent asset may be included in Notes Receivable with the related contingent liability as a contra account to Notes Receivable.

This procedure is objected to on the grounds that items are

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10. "The term 'contingent asset' is sometimes used to designate various types of claims and rights, sometimes uncertain in character and often indeterminate in amount, which may, under certain circumstances, materialize into valid property items." W. A. Paton (ed.) Accountants' Handbook (3rd ed.; New York: The Ronald Press Company, 1944), p. 443. A contingent asset is also defined as "an asset, the existence, value, and ownership of which depends upon the occurrence of a specified event or upon the performance or nonperformance of a specified act; contrasts with contingent liability, often growing out of such a liability." Eric L. Kohler, A Dictionary for
included among the assets which are not really assets. Contingent assets are not assets since they have no future economic benefit to the business enterprise (until they become actual assets). Contingent assets, then, should not be shown in the balance sheet as assets. It may be argued, however, that contingent assets are offset by contingent liabilities and the net result would be the same if both of them were excluded from the financial statements. This is true, but the fact remains that contingent assets are not assets, and should not be shown as such in the balance sheet. Therefore, if contingent assets are excluded from the balance sheet, then contingent liabilities must also be excluded.

**Showing both the contingent asset and liability in the balance sheet.** Where a contingent liability has a related contingent asset, the contingent asset is shown as an asset on the asset side of the balance sheet and the related contingent liability is shown as a liability on the liability side. This procedure calls for the recognition of contingent assets and liabilities as actual assets and liabilities. Contingent assets are not assets, and should be excluded from the balance sheet. Also contingent liabilities, as pointed out earlier, are not actual liabilities, and of course should not be shown as such in the balance sheet.

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Showing the contingent liability under a separate balance sheet heading. The contingent liability may be shown in its proper place in the balance sheet, but indented, so that it will not enter into the total. If this method is used, the contingent liability would be extended "short" in the balance sheet. Perhaps contingent liabilities could be presented in the following manner:

**CURRENT LIABILITIES**

| Accounts payable | $ 8,000 |
| Notes payable    | 4,000   |

**CONTINGENT LIABILITIES**

| Notes receivable  | $2,000 |
| discounted         |       |
| Accounts Receivable| 600    |

Total Current Liabilities $12,000

It can be seen that the use of this method results in the contingent liabilities being prominently displayed, yet they do not enter into the actual liability total. However, this method might confuse the financial statement reader because the contingent liabilities are included among the actual liabilities. This could leave the reader with the impression that they are just like actual liabilities. Furthermore, contingent liabilities are not actual liabilities and should not

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be included in the body of the balance sheet.

Footnote disclosure. The best solution to the problem of the disclosure of contingent liabilities is the use of footnotes. This method is recommended by most accounting writers as well as the American Accounting Association and the American Institute of Certified Public Accountants. Also modern accounting practice tends to prefer the use of footnotes for disclosure of contingent liabilities.  

There are several objections to the use of footnotes. For one thing, this method could lead to some confusion because of the possibility of too many footnotes. Perhaps this is true under present conditions; however, many of the items now contained in footnotes should be disclosed in the body of the financial statement. Therefore, if the items now disclosed in footnotes which properly belong in the


13 Accounting Trends and Techniques reports the following results in 1961: "A total of 264 survey companies referred to such contingencies in their 1960 annual reports. In most cases (251 companies) the disclosure was made either in footnotes or in the president's letter to the stockholders. The remainder (13 companies) presented the contingency within the balance sheet, in memorandum form, with no dollar amounts shown or with dollar estimates not included in the balance sheet total." American Institute of Certified Public Accountants, Accounting Trends and Techniques (15th ed.; New York: American Institute of Certified Public Accountants, 1961), p. 133.

body of the financial statements are eliminated, then perhaps there would be less footnotes for the financial statement reader to look at.

Another objection to the use of footnotes is that the contingent liability may be overlooked by the reader of the financial statement. If the reader fails to read all of the stockholders' report, then he may easily overlook some significant financial information. For example, the president's letter often contains important financial information. Therefore, failure to read the letter could mean that the reader has overlooked important financial data. Any financial statement reader who wishes to make a complete financial analysis of a company should read all the information (especially footnotes) contained in the stockholders' report. Further, it is generally assumed that the reader is sufficiently acquainted with accounting procedures to know that important financial data is often contained in footnotes.

Myers suggests several alternatives to the use of footnotes:

(a) showing the data on the face of the statements,
(b) presenting a supplementary schedule properly keyed to the statement and covered by an audit certificate,
(c) using the "financial review," and (d) omitting the information from the statement altogether.\(^{15}\)

Myers points out that many items can be handled directly on

\(^{15}\text{Ibid.}, \text{ pp. 385-386.}\)
the face of the statement. There are many items which can be shown parenthetically rather than in a footnote; however, contingent liabilities do not lend themselves to parenthetical disclosure (except, perhaps, notes receivable discounted or accounts receivable assigned) because of the length of the explanation needed to describe the nature of the contingent liability. To include the explanation in the body of the statement would tend to make the statement hard to read.

The use of separate schedules for disclosing contingent liabilities is nothing more than a modification of footnote disclosure. This method can be used where a company has several different types of contingent liabilities.

One of the alternatives to footnotes is the use of the financial review. Myers says that the financial review "is used to report in words significant items appearing on the statements and to give additional information, for example, construction programs and units of output." Thus, contingent liabilities would be disclosed in the "financial review" section of the stockholders' report. However, the question arises as whether the "financial review" can be considered as a part of the financial statements. Myers points out that if appropriate references are made to these comments in the financial statements, then there is no question of the fact of disclosure. Therefore,

\[16\text{Ibid., p. 387.}\] \[17\text{Ibid.}\]
he concludes, there is no objection to the use of the "financial review" as long as appropriate references are made in the financial statements. In fact, this is really nothing more than a modification of footnote disclosure.

The last method, that of omitting the information from the statements altogether, probably can be applied to some of the footnotes which tend to confuse, rather than help. However, contingent liabilities of a material amount should never be omitted from the statements. Their omission could have a significant effect on the financial statement reader's opinion of the financial position of a company.

Types of Contingent Liabilities

There are many different types of contingent liabilities which might require disclosure. It would be virtually impossible to discuss all of the different contingent liabilities to which a company might be subject; therefore, only the more common types of contingent liabilities will be discussed in this section.

Returnable containers, loss on purchase commitments, guarantees and warranties of products, self-insurance programs, long-term leases, and pension plans are often considered to be contingent

\[^{18}\text{Ibid.}\]
liabilities; however, since these items have already been discussed in Chapters V and VI, they will not be discussed in this chapter.

**Notes receivable discounted.** Notes receivable discounted are probably the most common of all contingent liabilities. This contingent liability results from the obligation of the endorser (the person or company discounting the note) to pay the holder in due course (usually a bank) the face amount of the note plus accrued interest and protest fees if the maker dishonors the note.

The accountant should be aware of the conditions under which a note receivable discounted may become an actual liability. The **Uniform Negotiable Instrument Law** is quite clear in this respect:

**Section 65.** Every person negotiating an instrument by delivery or by qualified indorsement, warrants--

1. That the instrument is genuine and in all respects what it purports to be;

2. That he has good title to it;

3. That all prior parties had capacity to contract;

4. That he has no knowledge of any fact which would impair the validity of the instrument or render it valueless.

But when the negotiation is by delivery only, the warranty extends in favor of no holder other than the immediate transferee.

The provision of subdivision 3 of this section does not apply to persons negotiating public or corporate securities, other than bills and notes.
Section 66. Every indorser who indorses without qualification, warrants to all subsequent holders in due course:

1. The matters and things in subdivisions 1, 2, and 3 of the next preceding section; and

2. That the instrument is at the time of his indorsement valid and subsisting.

And, in addition, he engages that on due presentment, it shall be accepted or paid, or both, as the case may be, according to its tenor, and that if it be dishonored, and the necessary proceedings on dishonor to be duly taken, he will pay the amount thereof to the holder, or to any subsequent indorser who may be compelled to pay it.\(^{19}\)

The warranties implied by a qualified (without recourse) endorsement imposes so slight a liability that it usually may be ignored. However, in the case of an unqualified endorsement (with recourse) there is a definite liability if the maker fails to pay the holder in due course when the note is due. The unqualified endorsement, then, gives rise to a contingent liability.

There are two generally accepted methods of recording notes receivable discounted (assuming that there is a contingent liability for notes receivable discounted). The first method involves the use of an account entitled "Notes Receivable Discounted." When a note receivable is discounted, this account, rather than Notes Receivable,

is credited with the face amount of the note. Then, when the note is paid, an entry is made debiting Notes Receivable Discounted and crediting Notes Receivable for the face amount of the note. If the note is dishonored, and the company has to pay it, then an entry is made debiting a receivable account and crediting cash for the total amount of the cash outlay. An entry is then made debiting Notes Receivable Discounted and crediting Notes Receivable for the face amount of the note.

At the end of the accounting period, Notes Receivable Discounted is deducted from Notes Receivable and the net amount of Notes Receivable is shown in the balance sheet. The amount of Notes Receivable Discounted should be disclosed by a footnote.

Another method of accounting for notes receivable discounted is to credit Notes Receivable instead of Notes Receivable Discounted at the time the note is discounted. A supplementary record is maintained of all notes receivable discounted. When a note receivable discounted is paid, a notation to this effect is made in the supplementary record. If a note is dishonored, a notation is also made in the supplementary record, but, in addition, an entry is made debiting a receivable account and crediting cash for the total amount of the cash outlay.

At the end of the accounting period, the total of all notes
receivable discounted which have not yet become due is disclosed in
a footnote.

Accounts receivable assigned. Some business enterprises
finance operations to some extent through the use of "accounts receiv-
able financing." Accounts receivable financing "involves an agreement
under which a financial institution purchases its customer's open
accounts as they arise (or advance him loans by the pledge of such
receivables) with recourse to him for credit losses and without notice
to his trade debtors."20

Accounts receivable sold under this type of agreement usually
call for a cash advance which may vary from 70 to 95 per cent of the
gross value of the accounts.21 Since the amount received from the
financial institution is less than the gross value of the receivables, the
assignor retains an equity in the accounts. Any returns, allowances
or discounts reduce this equity. If the equity is exhausted or reduced
to an amount the financial institution regards as being inadequate,
then the assignor sends the financial institution a check in an amount
sufficient to create an acceptable equity. When accounts are collected,

20 Clyde William Phelps, Accounts Receivable Financing as a
Method of Business Finance (Baltimore: Commercial Credit Company,
1957), p. 15.

21 Ibid., p. 22.
the related equity may be paid to the assignor immediately or periodically. 22

The financial institution usually charges a per diem interest rate on gross receivables (face value of the receivables) purchased varying from 1/40 of 1 per cent to 1/52 of 1 per cent, depending on the percentage of gross receivables advanced in cash. This per diem rate is applied to the average face value of accounts outstanding each month. The firm is billed at the end of each month for the interest charge in connection with the purchase of its accounts during the month by the financial institution. 23

Since the accounts receivable are sold "with recourse," the firm selling the accounts has a contingent liability similar to that for notes receivable discounted. Assume, for example, that X Company has $50,000 of accounts receivable and that it receives $16,000 in cash for assigning $20,000 of these accounts to a finance company.

The entry to record the assignment would be:

<table>
<thead>
<tr>
<th>Cash</th>
<th>$16,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity in assigned accounts</td>
<td>4,000</td>
</tr>
<tr>
<td>Accounts receivable assigned</td>
<td>$20,000</td>
</tr>
</tbody>
</table>

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Accounts Receivable Assigned should be deducted from Accounts Receivable, and the net amount of Accounts Receivable should be shown in the balance sheet along with the Equity in Assigned Accounts. The difference between the amount of the accounts assigned and the assignor's equity in such accounts, represents the amount of the contingent liability for assigned accounts. This contingent liability should be disclosed in a footnote.

In the above example, if a balance sheet was prepared immediately after the assignment was made, then the information in regard to accounts receivable would be presented as follows:

Current Assets

<table>
<thead>
<tr>
<th>Accounts receivable</th>
<th>$30,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity in assigned accounts</td>
<td>4,000</td>
</tr>
</tbody>
</table>

A footnote would be used to disclose the contingent liability of $16,000 for accounts receivable assigned.

If a balance sheet is prepared after collections have been made, then the contingency to be shown is the difference between the uncollected balance of the assigned accounts and the assignor's equity, not the difference between the original balance of the assigned accounts and the assignor's equity. 24

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24 For an excellent description of the procedures of accounting for collections, sales returns and allowances, discounts and bad debts in connection with accounts receivable assigned, see Finney and Miller, op. cit., pp. 213-214.
Sometimes a company has an agreement under which a financial institution agrees to purchase the company's accounts receivable as they arise without recourse to the company for credit losses. This outright sale of receivables is known as factoring. Where accounts receivable are factored, then there is no contingent liability since the accounts are sold without recourse. Such sales should be treated as sales of assets.

Accommodation paper or endorsements. The Uniform Negotiable Instrument Law defines an accommodation party as follows: "An accommodation party is one who has signed the instrument as maker, drawer, acceptor or indorser, without receiving value therefore, and for the purpose of lending his name to some other person." If a person wishes to lend his credit to another, he may sign a note payable to the person accommodated or to some person who has agreed to loan money to the accommodated person, or he may sign the note as co-maker with the accommodated person. If a person lends his credit to another in this manner, then he is primarily liable on the instrument to a holder of value even though the latter knows that

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26 Lusk, op. cit., p. 998.
he is merely an accommodation party. 27

Sometimes a person will sign an instrument as an accommodation endorser. He may endorse for the accommodation of the maker, acceptor, drawer, payee, or an endorser. An accommodation endorser has all the rights and assumes all the liabilities of a regular endorser. If the instrument is dishonored, then he is liable for its payment to a holder of value. 28

If an accommodation party is required to pay the instrument, he may recover the amount of the payment from the person accommodated. 29 Therefore, the accommodation party has a contingent asset in that he has the right to collect from the person accommodated.

If a company becomes an accommodation party, then it has a contingent liability which should be disclosed in a footnote. When the instrument is paid by the person accommodated, then the company no longer has a contingent liability. However, if the person accommodated dishonors the instrument, then an entry should be made debiting a receivable account and crediting cash for the total amount of the cash outlay.


28 Lusk, op. cit., pp. 878-879.

29 Anderson and Kumpf, op. cit., pp. 269-270.
Guaranteed bonds. Guaranteed bonds are those issued by one company but guaranteed as to principal or interest or both by another company. Usually these guarantees are made to facilitate the sale of securities that would otherwise not be marketable at a reasonable rate. The guarantor is usually a parent company or has some special interest in the affairs of the debtor corporation.

The legal nature of guaranteed bonds is extremely complicated and unsettled. There appear to be all sorts of graduations of liability on the guaranteeing corporation as well as many variations in the views of courts in interpreting contracts of guarantees of bonds. Floyd Burchett and Clifford Hicks divide contracts of guarantees into four types:

(1) those which are definitely valueless because of loose wording, poor legal construction, faulty provisions, etc.;
(2) those weak guarantees and endorsements under which the endorsing or guaranteeing corporation carries no liability unless the issuing corporation cannot or will not pay, and until legal action has been taken by the security holders; (3) strong guarantees in which the corporation definitely agrees to meet the payments of interest and principal whether the issuing corporation can or does

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not; and (4) assumed bonds, wherein the primary liability is assumed by the corporation.\(^{32}\)

The only way that a corporation's actual or expected liability can be determined, Burchett and Hicks say, is by examination of the wording of the documents involved and court decisions of the state.

From an accounting standpoint, however, it would appear that the corporation would have a contingent liability for guaranteed bonds if there is any possibility that the corporation would become legally liable for payment of interest or principal or both. The company, in addition to a contingent liability, also has a contingent asset. If the guaranteeing corporation has to make payments under a guarantee, then the corporation acquires, by operation of the law, all the rights which the bondholders have against the company whose bonds are guaranteed; that is, it has a legal right to collect all money properly paid under the guarantee.\(^{33}\)

The contingent liability arising under a guarantee should be disclosed by means of a footnote to the financial statements. The determination of whether a contingent liability actually exists will depend on the nature of the contract of guarantee, and such contracts

\(^{32}\)Ibid., 179.

\(^{33}\)Lusk, \textit{op. cit.}, p. 677.
should be carefully examined by the company's attorneys to determine the exact extent of the company's expected liability.

There are, in addition to bonds, other types of guaranteed obligations. For example, a holding company may guarantee the fulfillment of contracts made by subsidiaries for merchandise to be delivered at future dates. These guarantees should be handled in the same manner as bond guarantees. If the company does have a contingent liability in connection with such guarantees, then it should disclose the contingency in a footnote.

Patent infringement. A patent is "a grant by the Federal government to an inventor, giving him for a period of 17 years the exclusive right to produce and sell his invention."34 Although extreme care is taken in the issuance of patents to see that they are really new devices, no governmental warranty implies that the patentee shall have free and uncontested use of his invention.35 If encroachment is made upon his rights under the patent, the courts are open to him for protection and similar privileges are extended to all alike.

If a company does become involved in a patent infringement

34Kohler, op. cit., p. 354.

lawsuit, the accountant is faced with the problem of determining if the company has a contingent liability. This problem can be alleviated if the accountant confers with the company attorneys in regard to the extent of any future liability. If the attorneys are not sure of the outcome, then the company has a contingent liability. The contingency is usually of such nature that it is difficult to determine the amount of the liability because the final amount is determined by a judge or jury.

The company attorneys may also be of the opinion that the company has little chance of winning the lawsuit. Under these conditions, the company has a contingent liability if the actual amount of the liability cannot be determined. In any event, contingent liabilities in connection with patent infringement lawsuits should be disclosed in footnotes to the financial statements. The explanation should consist of a summary of the circumstances and the present status of the case.

If a company's attorneys are sure that the company has little chance of winning a case, and the amount of the liability can be estimated, then the company has incurred an actual liability. However, recognition of the liability in the financial statements may be objected to by management on the grounds that this procedure may indicate
to opposition an acceptance of guilt. 36 Under these conditions, a footnote which adequately describes the contingency would probably be the best solution to this problem. 37

Pending lawsuits. In addition to patent infringement lawsuits discussed above, there are many other lawsuits which may give rise to contingent liabilities. These lawsuits may arise out of the sale of defective materials, the actions of employees, accidents and so forth. Lawsuits of this nature present the same problems as do patent infringement lawsuits. Since these lawsuits have already been discussed in the section on patent infringement, they will not be discussed in this section.

Income tax disputes. The problem of estimating the income tax liability for the current fiscal year is discussed in Chapter V. In addition to the income tax liability relating to the current fiscal year, uncertainty often exists concerning the amount of taxes payable for prior years. A lag of two or three years often exists between the filing of the tax returns and the final settlement after review by the government. Furthermore, disputes between the taxpayer and the Treasury may create contingent liabilities not settled for several years. The


accountant should confer with the company's attorneys to determine the present stage of such disputes. If there is still some question about the final outcome of the dispute, then a footnote should be used to explain the nature of the dispute. In cases where an adverse judgment has been rendered, but the additional assessment has not yet been paid, the accountant should recognize the liability for additional taxes in the accounts.
CHAPTER VIII

SUMMARY AND CONCLUSIONS

Accounting for liabilities is one area of accounting in which improvements need to be made if financial statements are to accurately report the liabilities of the business enterprise. Improvements in the reporting of liabilities are important for two reasons: (1) the inaccurate reporting of liabilities can affect balance sheet assets and/or reported income; and (2) the omission of certain liabilities from the balance sheet can lead to misleading conclusions concerning the financial solvency of a business enterprise.

The improvement of liability accounting involves solutions to these three problems: (1) defining liabilities; (2) measuring liabilities; and (3) classifying liabilities.

Problem of defining liabilities. Many attempts have been made by accounting writers and organizations to define the term "liability." Most of these definitions have not provided satisfactory criteria for determining whether or not a credit item is a liability. The accounting definitions of liabilities given by the two leading accounting organizations will help to clarify this statement.

The American Institute of Certified Public Accountants defines
a liability as:

Something represented by a credit balance that is or would be properly carried forward upon a closing of books of accounting according to the rules or principles of accounting, provided such credit balance is not in effect a negative balance applicable to an asset.¹

This definition is almost completely useless for determining if an item should be designated a liability.

The American Accounting Association defines liabilities as:

The interest or equities of creditors (liabilities) are claims against the entity arising from past activities or events which, in the usual case, require for their satisfaction the expenditure of corporate resources.²

This definition is an improvement over the one cited earlier; however, it emphasizes the debtor-creditor relationship as a means of determining if a liability exists. The determination of both the debtor and creditor is strictly a legal matter. For a definition to be useful for accounting purposes, it must be much broader than a legal definition of the term. The adherence to a strict legal definition of the


term "liability" would result in the deletion from the balance sheet of many items presently classified as liabilities.

A liability exhibits certain characteristics, and these can be used in determining if an item is a liability. The following characteristics were obtained from a careful analysis of various definitions: (1) a liability is an obligation; (2) a liability involves a future outlay of money or its equivalent; (3) a liability is the result of a past or current transaction; and (4) the amount of the liability must be known or can be reasonably estimated.

In the first characteristic the term "obligation" connotes a duty to deliver assets or perform service for someone outside of the business enterprise. It also implies that there are claims or a series of claims against the business enterprise which require settlement in the future. In addition, the term "obligation" includes all legal "debts" as well as all claims which are not yet legal "debts" but will require a future outlay of cash or its equivalent.

For an item to be classified as a liability under the second characteristic, it must require a future outlay of money or its equivalent. The settlement of a specific liability may require a future outlay of assets or performance of service. This future outlay may be postponed by the substitution of another liability. In addition, a liability may be settled by conversion into ownership interest.
The third characteristic is that a liability is a result of a past or current transaction. A transaction involves a relationship between the business enterprise and some outside person or entity; that is, it involves an "external" business event. Thus, liabilities are a direct result of a past or current transaction between two distinct accounting entities. Accrued liabilities involve "internal" rather than "external" transactions. These "internal" transactions are the results of transactions involving outside entities; that is, accrued liabilities represent consequences of changes in values connected with the continuation through time of contractual relations previously undertaken with outsiders.

Under the fourth characteristic, the amount of the liability must be known or reasonably measurable before it can be recorded. However, this does not mean that a liability whose exact amount is not known should be excluded from the financial statements. The accountant, in such cases, should estimate the amount of the liability with as much accuracy as possible.

The four characteristics described above can be used to determine if a credit item can qualify as a liability. Each credit item discussed in this dissertation was carefully examined to determine if it possessed these characteristics.

**Problem of measuring liabilities.** The problem of measuring
a liability is usually solved by measuring the liability at its face or maturity value. This procedure is to be objected to on the grounds that the effective amount of a liability is the discounted value of the future cash outlay or series of cash outlays. Therefore, a liability, for accounting purposes, should be measured by the discounted value of all future cash payments. In the case of a liability which involves a future outlay of goods or services resulting from advances by customers, the liability should be measured by the amount of the advances by customers since this amount is the present value of the liability; that is, there is an interest element inherent in advances by customers, and this interest element arises because the value of the services to be rendered to the customers are greater than the value of the advance payments.

Where current liabilities explicitly recognize the element of interest, as in the case of certain promissory notes, the liabilities should be measured at their present value. However, where current liabilities do not explicitly recognize the element of interest, the liabilities should be measured by the amount by which they can be effectively discharged. This procedure may be criticized as being inconsistent with the measurement of other liabilities at their present value; however, the measurement of all current liabilities at their present values would be a time-consuming job for the accountant, and,
in most cases, the interest factor is not significant. Thus, from a practical standpoint, the interest factor can be ignored (except in the case where current liabilities explicitly recognize the element of interest) in the measurement of current liabilities.

Long-term liabilities should be measured by the present value of all future payments. The yield or effective rate of interest at date of issue should be used in determining the present value of a long-term liability. This procedure is sound since it is consistent with the cost basis for measuring assets. However, the principles of liability measurement based on the yield rate of interest can be easily adapted to the measurement of liabilities at current values.

Problem of classifying liabilities. The problem of the proper classification of liabilities is one which embraces the entire credit side of the balance sheet. There are two concepts on this subject: the entity concept and the proprietary concept.

The holders of the entity concept maintain that liabilities and proprietorship are not separate and distinct, but are interdependent parts of a larger class, equities. Thus, for balance sheet purposes, both liabilities and proprietorship are shown under the general heading of "equities." The accounting equation, assets equals liabilities plus proprietorship, reflects the entity concept.

The arguments advanced by the proponents of the entity concept
fall into three categories: (1) similarities between stockholders and creditors; (2) similarities between stocks and bonds; and (3) the corporation as a separate entity.

There are three reasons why there are similarities between stockholders and creditors. First, the stockholders of a corporation often act more like creditors than owners. Second, both the stockholders and creditors have contributed capital to the corporation, and both have claims against the assets according to their contracts. Third, stockholders and creditors can be grouped together in the same classification since both groups are bearing the risk of loss of their respective investments.

Stocks and bonds are similar in many respects. There are many types of stock which exhibit the characteristics of bonds. For example, a preferred stock is similar to a bond in view of its protective rights, retirement provisions, and limited return. Just as there are stocks that are similar to bonds, there are also bonds which are similar stocks. Income bonds, for example, have some characteristics which are usually associated with stocks.

The legal definition of a corporation as an artificial being existing separate and apart from the stockholders is often used as an argument for the acceptance of the entity concept. The debts and assets are those of the corporate entity and no individual stockholder
has title whatsoever to corporate property. Thus, the stockholders, like the creditors, have an equity in the total of the corporate assets.

Under the proprietary concept, the proprietor is the center of accounting, and all accounting processes relate to the basic nature of the proprietor's interest. There is a very significant distinction between liabilities and proprietorship, which distinction is reflected in the balance sheet by dividing the credit side into two separate sections: liabilities and proprietorship. The accounting equation, assets minus liabilities equal proprietorship, describes the proprietary concept.

There are many differences between liabilities and proprietorship, and these form the backbone of the proprietary concept. Although aspects of ownership may seem to be present in creditor as well as proprietary interests, there is still a legal distinction between liabilities and proprietorship. Despite the fact that the assets may be heavily mortgaged and bankruptcy imminent, it nevertheless remains true that the assets are still legally owned by the proprietary interest of the sole proprietorship or partnership. The corporation is usually considered a legal person; however, this does not discount the fact that there is still a legal distinction between stockholders and creditors. No matter how closely a preferred stock resembles a bond, there is still a legal line drawn between the two.
In recent years there has been a considerable amount of dissatisfaction with the entity and proprietary concepts. This dissatisfaction has led to a great deal of criticism, and in some cases, even to the development of new concepts. One criticism that some writers have pointed out is that neither the entity nor the proprietary concepts actually are followed in practice; rather, practice seems really to mix the two, even to the point of vacillation. Another criticism is that the entity and proprietary concepts both adopt a personality as the focus of attention. The use of personalized basis for accounting may result in the content of financial statements being affected by personal analysis; that is, issues will be decided not by the nature of the problem, but upon some extension of personality.

As a result of these criticisms, there have been a number of new concepts offered by various writers. These may eliminate the inconsistencies of the entity and proprietary concepts; however at the same time, they also create problems in other accounting areas. In addition, these concepts, like the proprietary and entity concepts do not conform to the legal concept of the business enterprise.

Since the proprietary and entity concepts have been accepted in both theory and practice, perhaps the best solution to the problem of selecting a concept of the business enterprise is for accountants to accept only one of these concepts, and by so doing, conformity can
be achieved in financial reporting. Both of these concepts have their strong points, but it is believed that the entity concept is more applicable to the modern business enterprise. Thus, the entity concept was employed in this work; however, the credit side of the balance sheet was still divided into a liability section and a proprietary section, and, at least to this writer, it makes very little difference whether the credit side is labeled "equities," or "liabilities and proprietorship."

Now that the problem of the classification of the credit side of the balance sheet has been settled, the next problem is the classification of the liability section of the balance sheet.

It is standard accounting practice to separate liabilities as well as assets into two groups: current and long-term. This classification scheme has led to the development of the working capital concept. This concept plays a very important role in the financial analysis of the business enterprise. Therefore, it is recommended that the present practice of segregating assets and liabilities into current and long-term be retained since it serves a very useful purpose in financial statement analysis.

There are two concepts of the classification of liabilities:

(1) the older one which uses a certain period of time, usually one year, as the basis for segregating liabilities into current and
long-term; and (2) the newer concept which is based on the operating cycle as a means of distinguishing between current and long-term liabilities; in addition, how the liability is to be paid is also considered.

The one-year rule is used by many accountants as a means of separating liabilities into current and long-term. The use of the one-year rule has the advantage of establishing a definite guide for classifying liabilities. Furthermore, the one-year rule aids in the standardization of the balance sheet since each firm will classify liabilities in the same way. The main criticism of the one-year rule is that it is highly arbitrary and inflexible, and therefore, the rigid application of this rule may lead to some misleading financial statements.

This criticism has caused a great deal of dissatisfaction among accountants and eventually led to the development of a new concept of liability classification. This new concept uses the operating cycle as a basis for classifying liabilities and furthermore, the classification of liabilities is determined by whether such liabilities are to be paid out of current assets or the creation of other current liabilities. This concept, as presented by most writers, has several inconsistencies in it.

By eliminating these inconsistencies, the concept of liability classification can be restated as follows: a current liability is one which will be payable within the operating cycle; however, in cases
where the operating cycle is extremely short or long, an arbitrary
time period such as one year may be used. In addition, a current
liability must also be reasonably expected to require for its liqui-
dation the use of assets properly classified as current or be replaced
by another liability which in turn will be payable from current assets.
Any liability not meeting these requirements is to be classified as
long-term.

The principles of liability accounting developed in this disser-
tation were applied to those liabilities about which there is some con-
trovery. Each liability was discussed in terms of these principles
of liability accounting. Rather than present some conclusions about
each liability discussed in this dissertation, only the more controversial
ones will be discussed at this time. For the purpose of this discussion,
liabilities are divided into two groups: current and long-term.

**Current liabilities.** Most accountants record notes payable at
their face or maturity value. This procedure is correct as long as
the value of the asset received in exchange for the note is equal to
the face amount of the note. However, if the asset value is different
than the face amount of the note, then the value of the asset should
be recorded as the amount of the note payable liability since this
amount is the present value of the liability.

The effective or yield rate of interest should be used in comput-
ing the amount of accrued interest on notes payable. The usual
procedure is to record accrued interest by a debit to Interest Expense and a credit to Interest Payable. A better procedure would be to credit the accrued interest to the note payable account rather than the interest payable account. There is no particular advantage in separating interest payable from the note payable liability. In fact, the consolidation of the interest payable and note payable liabilities has the advantage of presenting the total amount of the liability in the same account.

The accounting treatment of the credit item usually referred to as "deferred income tax" has evoked a considerable amount of controversy among accountants. Some accountants maintain that deferred income tax is a liability; however, if deferred income tax is considered from the standpoint of the characteristics of a liability, it becomes clear that it is not a liability.

Deferred income tax is not an obligation since there is no duty on the part of the company to deliver assets to the United States Treasury since this agency has no claim against the company. Furthermore, the government does not even recognize the existence of any such obligation for future income taxes.

There is also some question as to whether such taxes can be accurately estimated. There is a great deal of uncertainty as to the level of taxable income and tax rates in the future. Therefore, the
difficulty of forecasting future taxable income and income tax rates casts some doubts on the reliability of the amount designated as deferred income tax. The only conclusion that can be reached, then, is that deferred income tax is not a liability.

A dividend is recorded as a liability on the date it is declared. In the case of cash dividends, the amount to be recorded as a liability is the amount of cash to be paid out to stockholders. If dividends are to be paid in noncash assets, then the dividend liability should be measured by the market value of the noncash assets on the date the dividend is declared.

The practice of including in liabilities the items referred to as "unearned interest income" and "deferred gross profit on installment sales" is particularly objectionable. These items are not liabilities since they require no future outlay of funds.

The estimated liability for the future repair or replacement of products sold under a warranty or guarantee are usually recorded by a debit to an expense account and a credit to a liability account in the period in which the products are sold. A better procedure for recording the estimated liability is to consider the sales price of the product as consisting of two portions: (1) an advance by the customer to cover future service costs; and (2) the actual amount of the revenue received from the sale of the product. Therefore, when the product is sold an entry can be made debiting an asset account for the sales
price of the product. The credit part of the transaction will consist of two parts: (1) a credit to a liability account for the portion of the sales price considered to be an advance payment for future service costs and (2) a credit to a revenue account for the balance of the sales price. This procedure is to be recommended since it reflects the fact that any product sold under a warranty or guarantee includes in its selling price an amount to cover future repair and replacement of the product.

The estimated future returns and allowances on credit sales should be shown in the balance sheet as a contra to accounts receivable. However, if sales returns and allowances are made on cash sales, then the portion of cash sales which is going to be returned to customers should be considered as a liability since it is an obligation of the company; that is, a customer has a claim against the company if he decides to return a product sold to him by the company.

Estimated collection costs on receivables are not liabilities. The company has no obligation to pay out funds in the future since there are no claims against the company. For a claim to exist, someone outside of the business must have performed some sort of service for the firm for which he has not yet been paid. In this case, there has been no performance of service by a person outside of the company in connection with future collection of accounts. Thus, there is no claim against the company by an outside entity.
The general accounting procedure for recognizing losses arising from firm purchase commitments due to a decline in prices of the goods contracted for is to debit an expense or loss account and credit a liability account called "provision for losses on purchase commitments." Some writers object to this procedure, and suggest that a debit be made to an asset account (goods on order) and a credit to a liability account (accounts payable) for the full purchase price of the goods at the time the purchase commitment is made. The company, however, does not acquire the goods; it only acquires the right to purchase the goods. Since it would be virtually impossible to assign a value to this right, then neither an asset nor a liability can be recorded. However, the right to purchase goods is still an asset, but it is an asset whose value is indeterminate.

When there is a decline in the price of goods contracted for, it results in a decline in the value of the right to purchase goods since the company could conceivably purchase the goods from another company at a lower price. This decline in value can now be measured objectively since it is the difference between the price contracted for and the price at which the goods could be purchased elsewhere. However, since the right to purchase goods cannot be recorded in the accounts as an asset at the time the purchase contract is entered into, it would not be logical to record a "loss" resulting from a decline in
the price of goods contracted for even though such a loss can be measured objectively. Furthermore, this "loss" does not result in a "liability" since it is due to a decline in the value of an asset—right to purchase goods.

A reserve for repairs is not a liability, although it does involve a future outlay of funds which can be estimated with some degree of accuracy; however, the outlay of funds involves a future transaction, not a present or past transaction. In addition, there is no claim against the company since the repairs have not yet been made.

Long-term liabilities. The correct accounting treatment of long-term bonds has always been a troublesome problem to accountants. The solution to this problem involves the correct accounting procedures for (1) determining the proceeds of the bond issue, (2) recording the bond issue, (3) presenting the bond liability in the balance sheet, (4) refunding of bonds, and (5) recording of treasury bonds.

One problem facing the accountant is the determination of the items to be deducted from the selling price of a bond issue in arriving at the proceeds. It is common practice to deduct from the selling price of the bonds legal fees, printing costs, underwriting commissions, and other charges associated with the issuance of the bonds. This procedure is objected to on the grounds that these service costs
represent assets and should be amortized over the life of the bond issue. However, there is strong argument for deducted all costs related to the bond issue in arriving at the proceeds since this amount is the actual amount of funds realized by the company. Nevertheless, the payment of services connected with the issuance of bonds is an application of the funds received, not a reduction in the amount of such funds.

It is common accounting practice to record bonds payable at their face value with any difference between face value and proceeds either debited to bond discount or credited to bond premium. There is no objection to this method as long as the "interest method" is used for amortizing bond discount or premium. The use of this method results in the presentation of the bond liability (after deducting unamortized discount or adding unamortized premium to face value) on the balance sheet at its present value.

Although the above method is satisfactory, a much better approach to the problem of recording the bond liability is to credit the proceeds directly to a bond liability account. Under this method, the accrual of bond interest (the accrued interest is computed at the effective or yield interest rate) is made by debiting an expense account and crediting the bond liability account. When the interest is paid, an entry is made debiting the bond liability account for the amount of interest paid.
For balance sheet purposes, the bond liability is separated into two parts: the amount of bond liability currently payable and the amount of the long-term bond liability.

There are several advantages in this method of recording bonds payable. First, premium and discount on bonds will be completely eliminated from the accounts. Second, accounting for bonds payable is done on a basis consistent with that of accounting for bond investment. Finally, a more correct presentation of bond liabilities will be made, affording pertinent information for full disclosure.

The refunding of bonds gives rise to the problem of the correct accounting treatment for the difference between the retirement price of the bonds and their carrying (book) value. Some accounting writers maintain that this difference should be considered as a part of the cost of issuing the new bonds, and thus spread over either the remaining life of the old bond issue or the life of the new bond issue. One objection to this procedure is that the contract with the old group of bond holders is terminated by the redemption of the bonds at their call price as provided by the bond agreement. Therefore, the difference between call price and carrying value as well as unamortized issue costs should be charged to either income or retained earnings. In addition, the procedure of carrying forward this difference as an asset is objected to on the grounds that the company has not acquired
an asset; that is, this difference does not represent any future economic benefit to the company.

Bonds reacquired by the company which issued them with the expectation of a subsequent sale are usually referred to as "treasury bonds." These reacquired bonds are often shown in the balance sheet as assets. This practice is objected to since it results in the overstatement of both assets and liabilities. Bonds reacquired by a company should be accorded the same accounting treatment as is used for the retirement of bonds. If the bonds are reissued, the reissued bonds should be treated exactly like a new bond issue.

One of the many problems facing the accountant is the problem of the proper disclosure of long-term leases in the financial statements. Many writers attempt to solve this problem by using a footnote as a means of disclosure of long-term leases. This procedure is objected to because financial transactions of enormous impact are left out of the accounts in their entirety. The lease transaction should be considered a financial transaction in which an asset is acquired and a liability is created.

The liability and related asset resulting from a lease transaction should be measured at the present value of all future rental payments required under the terms of the lease. The interest rate for computing the present value can often be determined from the
lease agreement. If the interest rate cannot be determined from the
lease agreement, then the lessee will have to select a rate based on
the market rate adjusted for the lessee's credit-worthiness.

The lease liability is shown in the balance sheet in the long-
term liability section along with an appropriate explanation of the terms
of the lease agreement. In addition, any installments due within the
operating cycle are classified as current liabilities.

There are two major problems involved in determining the
liability for pension plans: (1) liability for past services and (2)
liability for current services.

The liability for past services should be immediately recog-
nizable to the extent of the accrued claims of employees on account
of services already rendered. This liability has all the characteristics
associated with a liability.

The liability for current services should be related, as nearly
as practical, to the services of the employees on which the pensions
are based. This method involves a credit to a liability account and
a debit to an expense account for the full current cost of the pension,
based on the services rendered by the employees during the account-
ing period.

Pension liabilities, like other liabilities, should be measured
at their present value. The computation of the present value requires
the use of actuarial techniques. Since computations based on actuarial techniques call for the services of a trained technician, the computation of the present value of pension liabilities was omitted from this dissertation.

The pension liability for unfunded plans should be shown as a long-term liability in the balance sheet. However, if a plan is fully funded and the company's liability for future pension payments is legally discharged upon payment into the pension fund, then the liability is omitted from the balance sheet. If the pension liability is partially funded, then the liability is reduced by the payments into the fund as long as the company's legal liability for future pension payments is discharged by such payments.

Long-term advances by customers should be measured at their present value. The initial liability is the amount received from the customer, which is, of course, the present value of the liability. The interest factor arises because the value of the services to be rendered is greater than the value of the advance payment received from the customer. In many cases, the interest rate can be determined from the transaction itself; however, under certain conditions there may be other implicit costs involved in the discount rate. Thus, it may be necessary to use the market rate of interest adjusted for the company's credit-worthiness.
There is no objection to the recognition of implicit interest costs in connection with the amortization of the liability for advances by customers. However, many accountants object to recognition of implicit interest costs in the accounts. In any event, the compound interest method for amortizing advances from customers should be used regardless of whether interest expense is recognized in the accounts.

A "reserve for self-insurance" may be created through a periodic charge to income. Frequently a "reserve" created in this manner is classified as a liability in the balance sheet. This "reserve" account is not a liability since it represents a possible future transaction which may never take place; it is not the result of a past transaction. Furthermore, there are no claims against the company nor does the company have any duty to deliver assets in the future to someone outside of the company.

**Contingent liabilities.** A contingent liability has three characteristics: (1) it is a result of a past event; (2) it depends on some future event taking place before it becomes an actual liability; and (3) the amount of the contingent liability may or may not be known. For example, a note receivable discounted at the bank is a contingent liability since it is the result of a past event--the discounting of the note--and a future event--the failure of the maker of the note to pay
the bank when the note is due--must take place before it becomes an actual liability. In this example, the amount of the contingent liability can be determined from the terms of the note.

There are several methods of presenting contingent liabilities in the balance sheet: (1) creating a reserve account by appropriation of retained earnings; (2) recording the asset at gross and deducting the contingent liability; (3) showing both the contingent asset and related contingent liability in the balance sheet; (4) showing the contingent liability under a separate balance sheet heading; and (5) using a footnote to disclose the contingent liability.

There are several objections to the use of reserves as a means of disclosing contingent liabilities. One objection is that the appropriation of retained earnings neither provides a cash fund nor strengthens the capital structure. Frequently readers of financial statements interpret a "reserve" account to mean that the company has a cash fund equal to the amount in the "reserve account." Thus, the use of a "reserve" could result in some misleading conclusions concerning the financial position of a company. Furthermore, the entire balance of retained earnings is, in effect, a reserve for contingencies, and subdividing this balance for the purpose of creating a reserve for contingencies would not be particularly helpful.

When a contingent liability involves a related contingent asset,
the amount of the contingent asset can be included in an asset account with the related contingent liability as a contra account. An alternative procedure would be to show the contingent asset as an asset in the balance sheet and to show the related contingent liability as a liability. Both of these procedures are objected to on the grounds that items are included among the assets and liabilities which are not actual assets and liabilities.

The contingent liability may be shown in its proper place in the balance sheet, but indented, so that it will not enter into the total. This method might confuse the financial statement reader because contingent liabilities are included among actual liabilities and this could leave the reader with the impression that they are just like actual liabilities.

The best solution to the problem of the disclosure of contingent liabilities is the use of footnotes. This method is recommended by most accounting writers as well as the leading accounting organizations. Also modern accounting practice tends to prefer the use of footnotes for disclosure of contingent liabilities.

Summary. In recent years accountants have emphasized the importance of the income statement in the reporting of financial information. This preoccupation of accountants with income measurement has had the effect of downgrading the importance of the balance sheet
in financial reporting. If the balance sheet is to regain its lost stature, then improvements must be made so that this statement will accurately reflect the financial position of the business enterprise.

Although there are many areas in which improvements need to be made in the balance sheet, this work has been primarily concerned with improvements in only one of these areas—liabilities. Improvement in liability accounting involves solutions to the problems of defining, measuring, and classifying liabilities. It has been the purpose of this work to present a theory of liability accounting which can be used to solve these problems. Each credit item discussed in this work was critically evaluated in terms of this theory of liability accounting.

The present-day emphasis of accounting on income determination often leads to the creation of certain accounts with credit balances which appear on the balance sheet as liabilities. The more common of these credit items are deferred income taxes, reserve for repairs, estimated future collection costs on receivables, and reserve for self-insurance. These items do not qualify as liabilities since each one lacks one or more of the following characteristics of a liability: (1) it is an obligation; (2) it requires a future outlay of money or its equivalent; (3) it is the result of a past or current transaction; and (4) it is subject to reliable estimation. Furthermore, certain items,
such as long-term leases, guarantees and warranties, and pension plans, are often omitted from the balance sheet even though they have all the characteristics of liabilities.

The accountant usually measures a liability at its face or maturity value. This is especially true in the case of long-term liabilities. For example, bonds payable are often shown in the balance sheet at their face or maturity value. The effective amount of this liability is not this value; it is the present value (computed at the yield rate of interest) of all future payments. Therefore, the liability for bonds payable should be measured at its present value. This can be best accomplished by crediting the proceeds of the bond issue to a liability account. In addition, accrued interest (computed at the yield rate of interest) is also credited to this same account. This procedure results in the measurement of the bond liability at its present value.

The above procedure should be used for recording all long-term liabilities. Where current liabilities explicitly recognize the element of interest, the above procedure should also be used for recording the liabilities. However, where current liabilities do not explicitly recognize the element of interest, the liabilities should be measured and recorded at the amount at which they can be effectively discharged.
The problem of classifying liabilities can be solved if the accountant adopts a logical scheme for classifying both liabilities and assets. The best approach to this problem is to use the operating cycle as a basis for separating assets and liabilities into current and long-term groups. Therefore, a current liability is one which will be paid within the operating cycle and which will reasonably be expected to require for its liquidation the use of current assets or the creation of other current liabilities. Liabilities not meeting these requirements are to be classified as long-term. A similar classification scheme should be adopted for classifying assets.

In addition to the problem of defining, measuring, and classifying liabilities, there is also the related problem of defining and reporting contingent liabilities. A contingent liability exhibits the following characteristics: (1) it is the result of a past event; (2) it depends on some future event taking place before it becomes an actual liability; and (3) the amount of the contingent liability may or may not be known. These characteristics can be used to determine if a contingent liability is present at balance sheet date. The problem of reporting contingent liabilities can best be solved by the use of footnotes to the financial statements to disclose the contingent liabilities.

The problems of defining, measuring, and classifying liabilities
are problems the accountant faces everyday. It is hoped that this work will aid the accountant in solving these problems.
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VITA
VITA

Cecil Dollar, Jr., the son of Cecil and Ruby Dollar, was born November 15, 1930, in Cleburne, Texas. He was graduated from Godley High School, Godley, Texas in June, 1948, and the following September entered Brantley-Draughon Business College of Fort Worth, Texas. In June, 1949, he enrolled at Arlington State College and after completing two years of college he was employed as an accountant for an industrial firm in Fort Worth, Texas.

In June, 1958, he entered Texas Christian University and in August, 1959, he received the Bachelor of Science in Commerce degree from this institution. After receiving this degree, he entered the graduate school of Arizona State University in September, 1959, and completed the requirements for the Master of Science degree in August, 1960 (degree conferred in June, 1961).

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EXAMINATION AND THESIS REPORT

Candidate: CECIL DOLLAR, JR.

Major Field: ACCOUNTING

Title of Thesis: ACCOUNTING FOR LIABILITIES

Approved:

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Major Professor and Chairman

Dean of the Graduate School

EXAMINING COMMITTEE:

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