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Current assets and current liabilities Working capital; Accounting Research Bulletin, no. 30

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Current Assets and Current Liabilities

Working Capital

1. The working capital of a prospective borrower has always been of prime interest to grantors of credit; and frequently working capital has been the subject, in bond indentures, credit agreements, and preferred stock agreements, of provisions restricting corporate actions with respect to its reduction or impairment. Many such contracts forego precise or uniform definitions and merely provide that current assets and current liabilities shall be determined in accordance with generally accepted accounting procedures. Considerable variation and inconsistency exist, however, in current practice with respect to their classification and display. In this bulletin the committee discusses the nature of current assets and current liabilities with a view to developing criteria as an aid to a more useful presentation thereof in financial statements.

2. The committee believes that, in the past, definitions of current assets have tended to be overly concerned with immediate or forced liquidation values. The discussion which follows takes cognizance of the tendency in recent years for creditors to rely more upon the ability of debtors to pay their obligations out of the proceeds of current operations and less upon the debtor's ability to pay in case of liquidation. It should be reemphasized that financial statements of a going concern are prepared on the assumption that the company will continue in business.[1] Accordingly, this statement represents a departure from any narrow definition or strict "one year" interpretation of either current assets or current liabilities; the objective is to relate the criteria developed to the operating cycle of a business.

3. Financial position, as it is reflected by the records and accounts from which the statement is prepared, is revealed in a presentation of the assets and liabilities of the enterprise. These assets and liabilities in statements prepared by manufacturing, trading, and service

[1] See "Examination of Financial Statements," page 2, published by the American Institute of Accountants.

enterprises, are generally classified and segregated and, if logically classified, summations or totals of the "current" or "circulating" or "working" assets and of related obligations, designated as "current liabilities," will permit the ready determination of *working capital.* Working capital, sometimes called net working capital, is represented by the excess of current assets over current liabilities and identifies the relatively liquid portion of total enterprise capital which constitutes a margin or buffer for meeting obligations to be incurred and liquidated within the ordinary operating cycle of the business. If the conventions and procedures of accounting relative to the identification and presentation of current assets and liabilities are made logical and mutually consistent, an analysis of the amount, basis of valuation, and composition of such assets and liabilities and their relation to the total assets or capital employed may provide valuable data for credit and management purposes by furnishing a reliable indication of current financial status and affording a sound basis of comparison from year to year with due regard to the increase or decrease of the net amount of current assets and current liabilities. It is recognized that there may be exceptions, in special cases, to certain of the inclusions and exclusions as set forth in this bulletin. When such exceptions occur, however, they should be accorded the treatment merited in the particular circumstances under the general principles outlined herein.

4. For accounting purposes, the term *current assets* is used to designate cash and other assets or resources commonly identified as those which are reasonably expected to be realized in cash or sold or consumed during the normal operating cycle of the business. Thus the term comprehends in general such resources as (a) cash available for current operations and items which are the equivalent of cash, (b) merchandise or stock on hand, or inventories of raw materials, goods in process, finished goods, operating supplies, and ordinary maintenance material and parts, (c) trade accounts, notes, and acceptances receivable, (d) receivables from officers (other than for loans and advances), employees, affiliates, and others if collectible in the ordinary course of business within a year, (e) installment or deferred accounts and notes receivable if they conform to normal trade practices and terms within the business, (f) marketable securities representing the investment of cash available for current operations, and (g) prepaid expenses such as insurance, taxes, unused royalties, current paid advertising service not yet received, and other items which, if not paid in advance, would require the use of current assets during the operating cycle.

5. The ordinary operations of a business involve a circulation of capital within the current asset group. Cash, when expended for

materials, finished parts, operating supplies, labor and other factory services, is accumulated as inventory cost. 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." A one-year time period is to be used as a basis for the segregation of current assets in cases where there are several operating cycles occurring within such time period. However, where the period of the operating cycle is in excess of twelve months, such as in the tobacco, distillery, and lumber businesses, the longer period should be used.[2]

6. This concept of the nature of current assets contemplates the exclusion from that classification of such resources as: (a) cash and claims to cash which are restricted as to withdrawal or use for other than current operations, are designated for expenditure in the acquisition or construction of noncurrent assets, or are segregated[3] for the liquidation of long-term debts; (b) investments in securities, whether marketable or not, or advances, which have been made for purposes of control, affiliation, or other continuing business advantage; (c) receivables arising from unusual transactions, such as the sale of capital assets or advances to affiliates, officers, or employees, which are not expected to be collected within twelve months; (d) cash surrender value of life insurance policies; (e) land and other natural resources; (f) depreciable assets; and (g) balances representing the unamortized or unallocated costs of services received or to be received which are fairly chargeable to the operations of several years, such as debt discount and expenses or bonus payments under a long-term lease.

7. The term *current liabilities* is used principally to identify and designate debts or obligations, the liquidation or payment of which is reasonably expected to require the use of existing resources properly classifiable 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, as in the case of payables incurred in the acquisition of materials

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[2] While the illustrations that have been used apply to industrial concerns, the same principles generally apply to other concerns.

[3] Even though not actually set aside in special accounts, funds that are clearly to be used in the near future for the liquidation of long-term debts, payments to sinking funds, or for similar purposes should also, under this concept, be excluded from current assets. However, where such funds are considered to offset maturing debt which has properly been set up as a current liability, they may be included within the current asset classification.

and supplies to 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 services[4], and debts which arise from operations directly related to the operating cycle, such as accruals for wages, salaries, commissions, rentals, or royalties. Other liabilities the regular and ordinary liquidation of which 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, and agency obligations arising from the collection or acceptance of cash or other assets for the account of a third party.[5] Income taxes should be included as current liabilities even though the entire amount may not be payable within twelve months.[6]

8. This concept of current liabilities would include operating reserves which are expected to be required to cover expenditures within the year. Operating reserves properly provide for known obligations (a) the amount of which can only be determined approximately (as in the case of provisions for accruing bonus payments) or (b) where the specific party or parties to whom payment will be made cannot as yet be designated (as in the case of estimated costs to be incurred in connection with guaranteed servicing or repair of products already sold). The classification, however, is not intended to include a contractual obligation falling due at an early date which is expected to be refunded[7], or debts the funds for liquidation of which have been accumulated in accounts of a type not properly classified as current assets. When the amounts of the periodic payments of an obligation are, by contract, measured by current transactions, as for example by rents or revenues received in the case of equipment trust certificates or by the depletion of natural resources in the case of property

[4] Examples of such current liabilities are obligations resulting from advance collections on ticket sales, the delivery of services for which will normally be made in the ordinary course of business. On the contrary, obligations representing long-term deferments of the delivery of goods or services would not be shown as current liabilities. Examples of such transactions are the issuance of a long-term warranty or the advance receipt by lessor of rental for the final period of a ten-year lease as a condition to execution of the lease agreement.

[5] In further elaboration of this concept, loans secured by life insurance policies would be classified as current liabilities when, by their terms or by intent, they are to be repaid within twelve months. The pledging of life insurance policies does not affect the classification of the asset any more than does the pledging of receivables, inventories, real estate, or other assets as security for a short-term loan. However, when a loan on a life insurance policy is obtained from the insurance company with the belief that it will not be paid but will be liquidated by deduction from the proceeds of the policy upon maturity or cancellation, the obligation would be excluded from current liabilities.

[6] See also *Accounting Research Bulletin* No. 23.

[7] There should, however, be full disclosure that such obligation has been omitted from the current liabilities and a statement of the reason for such omission should be given. CF Note [3].

obligations, the portion of the total obligation to be included as a current liability should be that representing the amount accrued at the balance-sheet date.

9. The monetary values at which various current assets are carried do not always represent their present realizable cash values. Accounts receivable net of reserves for uncollectible accounts, are effectively stated at the amount of cash estimated as realizable. However, practice varies with respect to the carrying basis for current assets such as marketable securities and inventories. In the case of marketable securities where market value is less than cost by a substantial amount and it is evident that the decline in market value is not due to a mere temporary condition, the amount to be included as a current asset should not exceed the market value. The basis for carrying inventories has been stated by the committee previously.[8] Accordingly, it is important that the amounts at which current assets are stated be supplemented by information which reveals, for temporary investments, their market value at the balance-sheet date, and for the various classifications of inventory items, the basis upon which their amounts are stated.

The statement entitled "Current Assets and Current Liabilities—Working Capital" was unanimously adopted by the twenty-one members of the committee.

NOTES

1. Accounting Research Bulletins represent the considered opinion of at least two-thirds of the members of the committee on accounting procedure, reached on a formal vote after examination of the subject matter by the committee and the research department. Except in cases in which formal adoption by the Institute membership has been asked and secured, the authority of the bulletins rests upon the general acceptability of opinions so reached. (See Report of Committee on Accounting Procedure to Council, dated September 18, 1939.)

2. Recommendations of the committee are not intended to be retroactive, nor applicable to immaterial items. (See Bulletin No. 1, page 3.)

3. It is recognized also that any general rules may be subject to exception; it is felt, however, that the burden of justifying departure

[8] See *Accounting Research Bulletin* No. 29.

from accepted procedures must be assumed by those who adopt other treatment. (See Bulletin No. 1, page 3.)

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