

## Current Liabilities

- liabilities are present obligations resulting from past transactions
- obligations must be paid in the future by the transfer of assets or services
- future payment date is also known as the maturity date
- two basic classifications of liabilities
  - current liabilities
  - non current liabilities
- **current liabilities** is a debt that will be paid within one year and from existing current assets or through the creation of other current liabilities
  - most companies pay current liabilities with current assets
    - paying an account payable by issuing a note payable
- **non current liabilities or long term liabilities** are debts that do not meet both criteria
- a company with more current liabilities than current assets often lacks liquidity
  - short term debt paying ability
- must look at total short and long term liabilities to assess a company's solvency
  - ability to pay interest and debt when due
- types of current liabilities
  - bank indebtedness
  - accounts payable
  - accrued liabilities - taxes, salaries, interest, unearned revenue, notes or loans payable

## Operating Line of Credit

- current assets do not always turn into cash at the exact time that current liabilities must be paid
- **operating line of credit** is known as a credit facility at a company's bank
  - helps them manage temporary cash shortfalls
  - the company has been pre authorized by the bank to borrow money - a set limit for when the money is needed
- interest is charged at a floating interest rate on amounts used from the line of credit
- **floating (variable) interest rates** changes as market rates change and

is based on the prime borrowing rate

- prime rate is the interest rate banks charge their best customers
  - is usually increased by a specific percent which matches company's risk profile
- **collateral** is a security required by banks as protection against a possible default on the loan by the borrower
  - includes some or all the company's current assets, investments, property, plant and equipment
- line of credit borrowings are usually on a short term basis
  - are repayable immediately upon request by the bank
  - repayment is rarely demanded without a notice
- line of credit makes it easy for company's to borrow money
  - they do not need to call or visit banks to arrange transactions
  - banks cover cheques written in excess of the bank account balance - up to the approved credit limit
- amounts drawn on an operating line of credit has three results at year end
  - negative balance
  - overdrawn
  - cash balance
- no special entry for overdrawn amounts
- normal credits to cash will accumulate and be reported as a bank indebtedness
  - in the current liabilities section of the statement of financial position

#### Sales Taxes

- taxes are always posed on products and services
- sales tax is expressed as a percentage of the sales price
- three types
  - Goods and Services Tax (GST)
  - Provincial Sales Tax (PST)
  - Harmonized Sales Tax (HST)
  - in quebec PST is known as the QST
- In Quebec a \$100 sale results in
  - \$5 tax of GST ( $\$100 \times 5\%$ )
  - \$8.93 of QST [ $(\$100 + \$5) \times 8.5\%$ ]
  - increased sales tax rate is 13.9% [ $(\$5 + \$8.93) / 100$ ]
    - rather than 13.5% (5% GST + 8.5% QST)

- when sales occur, retailers collect the sales tax from the customer and periodically (monthly) remits(sends) the sales tax collected to the designated collecting authorities
  - may be federal or provincial
- amount of sale and sales taxes are rung up separately on a cash register
- sale of \$10,000
- HST of \$1,300 (13%)

Mar. 25	Cash	11,300	
	Sales		10,000
	Sales Tax Payable ( \$ 10,000 × 13%)		1,300
	(To record sales and sales tax)		

- if subjected to a federal tax of \$500 (5%) and provincial sales tax of \$700 (7%)

Mar. 25	Cash	11,200	
	Sales		10,000
	Sales Tax Payable [ ( \$ 10,000 × 5%) + ( \$ 10,000 × 7%) ]		1,200
	(To record sales and sales taxes)		

- when sales taxes are remitted, the entry is
  - sales tax payable is debited
  - cash is credited
- sales tax payable is used for both GST and PST

#### Property Taxes

- businesses who own property pay property taxes each year
- taxes are charged by the municipal and provincial governments
- are calculated at a specified rate
- property taxes are for a calendar year
  - however, bills are not issued until the spring of each year

Mar. 1	Property Tax Expense ( \$ 6,000 × <sup>2</sup> / 12 )	1,000	
	Property Tax Payable		1,000
	(To record property tax expense for January and February)		

- after the payment of the tax, expenses are recorded as well
  - recorded for months March, April and May
  - 5 months that have passed are recorded as a property tax

expense

- remaining 7 months are recorded as a prepayment

May 31	Property Tax Payable	1,000	
	Property Tax Expense ( $\$ 6,000 \times 3 / 12$ )	1,500	
	Prepaid Property Tax ( $\$ 6,000 \times 7 / 12$ )	3,500	
	Cash		6,000
	(To record payment of property tax for January through December)		

- after the property tax has been paid for, liabilities have a zero balance
  - prepayment still exists

Dec. 31	Property Tax Expense	3,500	
	Prepaid Property Tax		3,500
	(To record property tax expense for June through December)		

## Payroll

- employers incur three types of liabilities related to the salaries/ wages of employees'
  - net pay owed to employees
  - employee payroll deductions
  - employer payroll obligations
- management personnel are generally paid **salaries**
  - expressed as a specific amount per week, per two weeks, per month, per year
- part time employees or employees paid on an hourly basis or by work produced are paid **wages**
- total amount of salaries or wages earned by the employee is called **gross pay**
- an employer's total salaries and wages do not include payments made for services of professionals
  - such as accountants, lawyers, architects etc.
- professionals are independent contractors rather than salaried employees
  - payments to these professionals are called **fees** not a salary or wage
- second liability is the amount of employee **payroll deductions** required by law to be deducted from an employees' gross/total pay
- payroll deductions can be mandatory or voluntary

- mandatory payroll deductions includes amounts withheld for federal/ provincial income taxes, CPP contributions, EI premiums
- voluntary deductions for benefits include health and pension plans, union dues, charitable contributions
- **net pay** is an employees gross pay, total earnings LESS any employee payroll deductions withheld from an employees' earnings
  - is the amount the company must pay to the employee
- third liability is the employer payroll obligations
  - employers are expected to pay payroll costs that are charges on certain payroll deductions
    - employer's share of CPP and EI
- provincial governments require employer funding of a worker's compensation plan
- contributions plus items (employer sponsored health plans and pensions, compensated absences) referred to as **employee benefits**
- employer's share of these costs is recorded as an employee benefits expense
- weekly payroll for the company is recorded as followed:

Mar. 7	Salaries Expense	100,000	
	CPP Payable		4,950
	EI Payable		1,780
	Income Tax Payable		20,427
	United Way Payable		2,395
	Union Dues Payable		1,037
	Salaries Payable		69,411
	(To record payroll and employee deductions for the week ending March 7)		

- while employee payroll deductions are part of salaries expense, employer payroll costs are not
- employer payroll costs are debited to a separate expense account -> Employee Benefits Expense
- following entry is made to record the employer's expense and liability for its share of the payroll costs or employee benefits

Mar. 7	Employee Benefits Expense	11,947	
	CPP Payable		4,950
	EI Payable		2,492
	Workers' Compensation Payable		1,575
	Health Insurance Benefits Payable		2,930
	(To record employer's payroll costs on March 7 payroll)		

- entry for the payment of weekly payroll:

Mar. 7	Salaries Payable	69,411	
	Cash		69,411
	(To record payment of the March 7 payroll)		

- recording the accrual of payroll and payment of payroll is done in separate entries -> however they can be combined and recorded in a compound entry

#### Short Term Notes Payable

- a promissory note or note payable is a promise to repay specified amount of money at a fixed future date or on demand
- are often used instead of Accounts Payable
  - because they give the lender written documentation of the obligation
  - helps if legal action is needed to collect debt
  - notes payable are frequently issued to meet short term financing needs
- notes due for payment within on year of the balance sheet date are classified as current liabilities
- most notes are interest bearing
  - interest due monthly or at maturity
- short term notes can have floating interest rates
  - usual for them to have a fixed interest rate
- **fixed interest rate** is a constant rate for the entire term of the note
- notes payable are the opposite of notes receivables
- differences between accounts and notes payable
  - account payables are informal promises to pay
  - note payables are written promises to pay that gives the payee a stronger legal claim
  - account payables arise only from credit purchases (amounts

owed to suppliers)

- note payables can be used for credit purchases, extending an account payable beyond normal amounts or due dates, or to borrow money
- account payables are usually due within a short period of time
- note payables can be extended for longer periods
- account payables do not incur interest unless the account is overdue
- note payables usually bear interest for its entire duration
- HSBC Bank lend \$100,000 to Williams LTD. on March 1
  - it is a loan from a bank -> therefore commonly referred to as a bank loan payable
  - loan due in four months, July 1 with 6% interest with principal amount
  - payable at maturity
- journal entry when the \$100,000 is received

Mar. 1	Cash	100,000	
	Bank Loan Payable		100,000
	(To record receipt of four-month, 6% bank loan from HSBC)		

- as interest accrues over the life of the bank loan, it should be recorded periodically
- adjusting entries are required to recognize interest

Mar. 31	Interest Expense	500	
	Interest Payable		500
	(To accrue interest for March on HSBC bank loan)		

- current liabilities of the balance sheet will show
  - bank loan payable at \$100,000
  - interest payable of \$500
- interest expense at \$500 in other expenses and losses on the income statement
- at maturity, Williams Ltd. must pay principal of the loan \$100,000 plus \$2,000 ( $100,000 \times 6\% \times 4/12$ )
- \$500 has been accrued already
- interest must be updated for \$1,500 ( $100,000 \times 6\% \times 3/12$ ) april - june

July 1	Interest Expense	1,500	
	Interest Payable		1,500
	(To accrue interest for April, May, and June on HSBC bank loan)		

July 1	Bank Loan Payable	100,000	
	Interest Payable ( \$ 500 + \$ 1,500)	2,000	
	Cash ( \$ 100,000 + \$ 2,000)		102,000
	(To record payment of HSBC bank loan and interest at maturity)		

#### Current Maturities of Non Current Debt

- companies have a portion of non current debt due in the current year
- adjusting entries are not needed to recognize current maturities of non current debt
- recognized on the statement of financial position
- example
  - a company borrows \$25,000 on Jan 1 for 5 years
  - terms of the loan specify that each Jan 1, starting in 2013, \$5000 of the note will be repaid
  - when financial statements are prepared on Dec 31, 2012, \$5000 should be reported as a current liability, \$20,000 as a non current liability


#### Statement Presentation and Analysis

##### Presentation


- gains on bond redemptions are reported in the 'other revenues and gains' section of the statement
- losses on bond redemptions and interest expense are reported separately
  - in the other expenses and losses section

##### Current Liabilities

- listed in order of liquidity
  - by due date

CANADA POST Balance Sheet (partial) December 31, 2010 (in millions)		
Current liabilities		
Accounts payable and accrued liabilities		\$459
Salaries and benefits payable		576
Deferred revenue		120
Outstanding money orders		41
Current portion of long-term debt		13
Total current liabilities		1,209

### Non Current Liabilities

CANADA POST Balance Sheet (partial) December 31, 2009 (in millions)		
Non-current liabilities		
Long-term debt		\$1,095
Accrued pension, other retirement and post-employment benefit liability		2,950
Future income tax liabilities		40
Other long-term liabilities		37
Total non-current liabilities		4,122

- are usually reported and measured at amortized cost
- valuing financial liabilities at fair value normally applies to only complex financial instruments

### Provisions and Contingent Liabilities

- liabilities can be certain or uncertain
- **certain liabilities** are liabilities with a known payee, due date, amount payable
  - includes accounts payable, other types of liabilities
- **uncertain liabilities** are liabilities for which we may not know who we owe, when we owe or how much we owe
  - known as provisions or contingent liabilities
- **provisions** liabilities of uncertain timing or amount
  - no uncertainty that a charge will result
  - example: product with a warranty
  - recorded in the accounts using reliable estimates based on past experience and future expectations
- **contingent liabilities** are existing or possible obligations arising from past events
  - liability is contingent or dependent on whether or not uncertain

or future event occurs

- confirming either its existence or the amount payable - or both
- example: loan guarantee
  - when one company guarantees/promises to assume the loan obligation if the other company is unable to repay the loan
  - guaranteeing company incurs an actual liability and a loss
    - loss only if borrower does not make payments on loan
- example: unsettled lawsuit
- accounting rules require that uncertain liabilities be recorded or disclosed in the notes to the financial statements

#### Analysis

#### Liquidity

- measures a company's short term ability to pay its maturing obligations and to meet unexpected needs for cash
- Companies who keep fewer liquid assets on hand must rely on other sources of liquidity
  - **operating lines of credit**
    - companies borrow money from short term lines of credit as necessary
- if liquidity ratios are low, lines of credit should be high to compensate
- higher ratios indicated improved performance

#### Solvency

- measures a companies ability to repay its long term debt and survive over long periods of time
- **debt to total assets** Total Liabilities/ Total Assets
  - indicates the extent to which a company's assets are financed by debt

DEBT TO TOTAL ASSETS = $\frac{\text{TOTAL LIABILITIES}}{\text{TOTAL ASSETS}}$		
(in millions)	2010	2009
Canada Post	$\frac{\$5,331}{\$7,600} = 70.1\%$	$\frac{\$4,213}{\$6,029} = 69.9\%$
UPS	76.0%	75.9%
Industry average	33.8%	31.5%

- lower the better
- less debt is better than more debt
- **times interest earned** gives indication of a company's ability to meet interest payments as they come due
  - $\frac{\text{SUM OF PROFIT} + \text{INTEREST EXPENSE} + \text{INCOME TAX EXPENSE}}{\text{INTEREST EXPENSE}}$
  - a company may have a high debt to total assets ratio but still be able to cover interest payments
  - a company may have a low debt to total assets ration and struggle to cover its interest payable
- earnings before interest and taxes - **EBIT**
  - can be found directly on the income statement
  - calculated by adding: INTEREST EXPENSE AND INCOME TAX EXPENSE TO PROFIT
    - are amounts previously deducted to determine profit
    - added back to remove them from profit before interest and taxes

TIMES INTEREST EARNED = $\frac{\text{PROFIT} + \text{INTEREST EXPENSE} + \text{INCOME TAX EXPENSE (EBIT)}}{\text{INTEREST EXPENSE}}$		
(in millions)	2010	2009
Canada Post	$\frac{\$439 + \$30 - \$136}{\$30} = 11.1 \text{ times}$	$\frac{\$281 + \$7 + \$95}{\$7} = 54.7 \text{ times}$
UPS	16.6 times	8.6 times
Industry average	16.3 times	14.1 times

- higher the better for the times interest earned

- **operating leases** treated as periodic rentals
  - no assets or liabilities are recorded on the company's books
  - finance and capital leases treated like a debt financed purchase
    - increases both assets and liabilities
  - often are short term
  - off balance sheet financing, when an operating lease covers a long period of time
    - refers to situations where liabilities are not recorded on the statement of financial position
- **credit ratings** agencies who provide opinions about a company's ability to make timely payments on its short and long term debt
  - short term debt measured on an R scale
    - r1 is the highest credit quality