

Busi 293 Notes

Chapter Ten

Current Liabilities

Very few businesses pay cash for all of their expenditures and expenses. Rather they owe monies to suppliers who have provided inventory on account and/or owe amounts to other creditors who have provided services to the company. These amounts will need to be paid relatively quickly. In accounting terms these are known as current liabilities which are defined to be short-term obligations that will be repaid within the current operating cycle of the business or within one year of the balance sheet date, whichever is longer. In our case it will usually be within one year of the statement of financial position date.

The textbook separates liabilities as follows:

- Actual Liabilities - specific amounts which are owed to identifiable creditors
- Provisions – relate to liabilities where either the amount or the timing is uncertain
- Contingent Liabilities – a possible liability that is created as a result of a past event but will only be confirmed once some future event occurs or fails to occur.

Actual Liabilities

We have prepared Classified Statement of Financial Positions which separate current and long-term liabilities. The following is a list of commonly encountered current liabilities:

- Accounts payable- amounts owed to suppliers of inventory
- Accrued liabilities- expenses which that have been incurred but not yet paid (often providers of services)
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Actual Liabilities continued

- Income tax payable- amount owed to Canada Revenue Agency for taxes on income earned in the year
- Taxes other than income taxes – PST, GST etc.
- Payroll liabilities- amount owed to employees
- Interest payable- interest owed but not yet paid
- Notes payable - amounts owed to lenders who required the entity to sign promissory notes. A promissory note requires the borrower to promise to repay a sum of money on a particular day with a stated rate of interest
- Current portion of long-term debt – the amount of long-term debt owed within one year of the balance sheet
- Unearned revenue - the amount of unearned revenue which the entity believes will be earned within the next twelve months of the balance sheet date

Textbook reference A provides brief descriptions of each of the above noted categories.

Provisions

As noted above, when the amount or timing of a liability is uncertain, it is referred to as a provision. A provision must be recognized when:

- an entity has a present obligation as a result of a past event
- it is probable that cash or other assets will be required to settle the obligation, and
- a reliable estimate can be made of the amount of the obligation.

Warranty liabilities are provisions as the amount and/or timing is uncertain. The provision arises from the sale of a product. Any entity which offers a warranty on its product is faced with estimating the liability at each balance sheet date. Please refer to textbook reference B for an example of the financial statement note disclosure related to provisions.

Provisions continued

As indicated in Textbook reference C, the liability for the provision is established and then reduced as actual warranty claims are made by customers. Think of the difficulty of establishing a warranty liability on a new product - it will be an estimate at best, probably dependent on the engineering department's evaluation of the product. When claims are made, notice that inventory is credited if parts are removed from inventory, salaries payable is credited if labour is required to correct any product deficiencies or cash is reduced if payments are made.

Provisions are also made for legal and tax disputes, closing of stores or and restricting of production, sales or administrative structures.

While there is uncertainty with respect to the amount of the liability, management should make every effort to establish a reasonable estimate of the liability and match it to the revenue recognized in the period.

Contingent liabilities

A contingent liability is defined as:

- (a) A possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or
- (b) A present obligation that arises from past event but is not recognized (i.e. no provision is established) because:
 - (i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or
 - (ii) the amount of the obligation cannot be measured with sufficient reliability.

Contingent liabilities continued

Examples of contingent liabilities include lawsuits, tax reassessments environmental problems and loan guarantees. Because the outcome is unknown, it is unclear whether a liability will ever occur. Regardless of the outcome, the reader of the financial statement would be interested in the circumstances surrounding these potential liabilities.

The treatment of contingencies is determined by following:

- If there is a present obligation and it is probable (more likely than not) of an outflow of resources embodying economic benefits, a provision should be recorded in the financial statements and disclosure of the item included in the financial statements.
- If there is a present obligation or it is probable that an obligation will arise but the amount cannot be reliably estimated, then no provision will be recorded but financial statement disclosure is required.
- If there is a present obligation or a possible obligation that may, but probably will not, require the outflow of resources embodying economic benefits, no provision will be recorded but financial statement disclosure is required.
- If there is a present obligation or a possible obligation but the likelihood of an outflow of resources embodying economic benefits is remote, no provision will be recorded nor is there a requirement to make any financial statement disclosure.

Textbook reference D indicates that the treatment of contingencies is slightly different under Accounting Standards for Private Enterprises.

Commitments

Commitments reflect contractual agreements to enter into transactions with other parties. Commitments to buy or sell goods or services or to make specific payments are not normally recorded in the accounting records as long as there is no exchange transaction. However such arrangements are relevant to financial statement users and help in predicting a company's future cash flow.

Financial Statement Ratios

Working capital refers to the difference between current assets and current liabilities. It addresses whether a company has sufficient current assets to satisfy current liabilities. Significant changes in working capital should be noted and investigated.

Recall the current ratio from Chapter 2 – current assets/current liabilities. A variation of that ratio is the **quick ratio** which adjusts current assets to quick assets – cash, short-term investments and net receivables.

The calculation is then **quick assets/current liabilities**.

While a high quick ratio shows a great deal of liquidity, it may also suggest that management is not maximizing the use of company assets.

Financial Statement Ratios continued

Suppliers expect to be properly treated. Failure to pay accounts on a timely basis is both frustrating and costly. **The trade payables turnover ratio** attempts to determine the efficiency with which management is meeting its obligations to suppliers.

The calculation is:

Cost of good sold/ Average net trade payables

Please note that Cost of goods sold is used as an approximation of purchases made in the period. The higher the ratio, the more often the company is paying its suppliers.

If one were interested in the average age of trade payables the following ratio is used:

= 365/ Trades payable turnover ratio

In this ratio, a higher ratio indicates trade payables are outstanding for a longer period of time – a negative from a supplier's point of view.