

CHAPTER 13

NON-FINANCIAL AND CURRENT LIABILITIES

CHAPTER TOPICS CROSS-REFERENCED WITH THE *CICA HANDBOOK*, PART I (IFRS) AND PART II (ASPE)

Cash and Cash Equivalents	IAS 7	Section 1540
Current Assets and Current Liabilities	IAS 1	Section 1510
Non-financial liabilities	IAS 37 and IFRIC 13	—
Asset Retirement Obligations	IAS 37	Section 3110
Contractual Obligations	IAS 37	Section 3280
Contingencies	IAS 37	Section 3290
Financial Instruments—Recognition and Measurement	IAS 39	Section 3856
Financial Instruments—Presentation	IAS 32	Section 1521
Financial Instruments—Disclosure	IFRS 7	Section 3856
Disclosure of guarantees	IAS 37	AcG-14
Proposed amendments to IAS 37	IASB Exposure Draft ED/2010/1	—

LEARNING OBJECTIVES

1. Understand the importance of non-financial and current liabilities from a business perspective.
2. Define liabilities, distinguish financial liabilities from other liabilities, and identify how they are measured.
3. Define current liabilities and identify and account for common types of current liabilities.
4. Identify and account for the major types of employee-related liabilities.
5. Explain the recognition, measurement, and disclosure requirements for decommissioning and restoration obligations.
6. Explain the issues and account for unearned revenues.
7. Explain the issues and account for product guarantees and other customer program obligations.
8. Explain and apply two approaches to the recognition of contingencies and uncertain commitments, and identify the accounting and reporting requirements for guarantees and commitments.
9. Indicate how non-financial and current liabilities are presented and analyzed.
10. Identify differences in accounting between IFRS and ASPE and what changes are expected in the near future.

CHAPTER REVIEW

1. Chapter 13 explains the basic principles regarding accounting and reporting for common current liabilities and a variety of non-financial liabilities. Contingencies, commitments, and guarantees are also addressed. Explanations regarding non-financial liabilities under international standards are based on current IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and materials underlying expected revisions to this standard. In 2010 the IASB released an exposure draft of amendments to IAS 37 and invited comments on the draft. As of April 2012, the project has been paused pending other discussions.

Current Liabilities

2. Existing IFRS and ASPE state liabilities have three essential characteristics:
 1. They embody a duty or responsibility.
 2. The entity has little or no discretion to avoid the obligation.
 3. The transaction or other event creating the obligation has already occurred.

This is similar to the current proposed definition in Conceptual Framework—Elements and Recognition Project that states liabilities have three essential characteristics:

1. They exist at the present time
2. They represent economic burdens or obligations
3. The obligations are enforceable on the obligor entity.

However, the key difference between the two is in how they are applied – the new definition will result in recognizing a liability whenever an unconditional obligation exists at the reporting date. Any uncertainty about the amount to be given up in the future is considered when measuring the liability.

3. A distinction is made between financial liabilities and those that are not financial in nature. Financial liabilities are contractual obligations to deliver cash or other financial assets to another entity, or to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity. For example, unearned revenue is not a financial liability because it does not require the delivery of cash or another financial asset. Legislated liabilities such as income taxes payable are not created by a contract so they do not qualify as financial liabilities either.

4. Financial liabilities are initially measured at fair value and subsequently at amortized cost. Short-term financial liabilities, such as account payable, are accounted for at their maturity value if the amount is immaterial. Non-financial liabilities under ASPE are generally measured at the fair value of the goods or services to be delivered in the future. Under IFRS, non-financial liabilities are measured initially and at each subsequent reporting date at the best estimate of the amount the entity would rationally pay at the statement of financial position date to settle the present obligation.
5. Liabilities are classified on the statement of financial position as **current** obligations or **long-term** obligations. **Current liabilities** are those obligations whose liquidation is reasonably expected to require use of existing resources **classified as current assets**, or the creation of other current liabilities.
6. The relationship between current assets and current liabilities is an important factor in the analysis of a company's financial condition. A liability is classified as current under IFRS when ONE of the following conditions are met:
 1. It is expected to be settled in the entity's normal operating cycle
 2. It is held primarily for trading
 3. It is due within 12 months from the end of the reporting period
 4. The entity does not have an unconditional right to defer its settlement for at least 12 months after the statement of financial position date.

COMMON CURRENT LIABILITIES

Bank Indebtedness and Credit Facilities

1. The cash position of a company is closely related to its bank indebtedness for current operating purposes and its **associated line-of-credit or revolving debt** arrangements. Instead of having to negotiate a new loan every time the company needs funds, it generally enters into an agreement with its bank to make multiple borrowings up to a negotiated limit. The company draws on the fund as needed and is normally required to make pre-negotiated repayments.

Accounts Payable

1. **Accounts payable** represent obligations owed to others for goods, supplies, and services purchased on open account. These obligations, commonly known as **trade accounts payable**, should be recorded to coincide with the receipt of the goods or at the time title passes to the purchaser. Attention must be paid to transactions occurring near the end of one accounting period and at the beginning of the next to ascertain that the goods received (inventory) are in agreement with the liability (accounts payable) and that both are recorded in the proper period.

Notes Payable

1. **Notes payable** are written promises to pay a certain sum of money on a specified future date and may arise from sales, financing, or other transactions. Notes may be classified as short-term or long-term, depending on the payment due date.
2. Short-term notes payable resulting from borrowing funds from a lending institution may be **interest-bearing** or **non-interest-bearing** (i.e., zero-interest-bearing). Interest-bearing notes payable are reported as a liability at the face amount of the note along with any accrued interest payable. A zero-interest-bearing note does not explicitly state an interest rate on the face of the note. Interest is the difference between the present value of the note and the face value of the note at maturity. For example, assume that Landscape Corp. issues a \$100,000, four-month, zero-interest-bearing note payable to the Provincial Bank on March 1. The note's present value is \$96,154, based on the bank's discount rate of 12%. The entry to record this transaction for Landscape Corp. would be as follows:

Cash	96,154	
Notes Payable		96,154

3. The currently maturing portion of long-term debts may be classified as a current liability. When a portion of long-term debt is so classified, it is assumed that the amount will be paid within the next 12 months out of funds classified as current assets.

4. A liability due on demand (callable debt) is classified as current even if the debt agreement has a payment schedule over several years. Liabilities that become callable by the creditor because of a violation of a debt covenant will be classified as current, even if previously classified as long-term debt. Under IFRS, this classification will hold even if the lender agrees between the balance sheet date and the date the financial statements are released that it will not demand repayment because of the violation. This is because the lender, not the entity, was the one holding the unconditional right to defer the payment beyond 12 months from the reporting date. Under ASPE, the liability is reclassified as current unless:
 - a. the creditor waives the covenant (agreement) requirements, **or**
 - b. the violation has been cured within the grace period that is usually given in these agreements, **and**
 - c. it is likely that the company will not violate the covenant requirements with a year from the statement of financial position date.

Short-Term Debt Expected to be Refinanced on a Long-Term Basis

1. Under **IFRS**, if the debt is due within 12 months from the reporting date, it is classified as a current liability even if a long-term financing has been completed before the financial statements are released. The only exception is if, at the statement of financial position date, the entity expects to refinance it or roll it over under an existing agreement for at least 12 months and the decision is solely at its discretion. Under ASPE, short-term obligations expected to be refinanced on a long-term basis could be **excluded** from current liabilities if the liability has been refinanced on a long-term basis or there is a non-cancellable agreement to do so before the financial statements are completed and nothing stands in the way of completing the refinancing.

Dividends Payable

1. **Cash dividends payable** are classified as current liabilities during the period subsequent to declaration and prior to payment. Once declared, a cash dividend is a binding obligation of a corporate entity, payable to its shareholders. **Stock dividends payable** are reported in the shareholders' equity section when declared, and dividends payable in the form of additional shares are not recognized as a liability.

Rents and royalties payable

1. Rents and royalties are contractual agreements covering rent or royalty payments which are conditional on the amount of revenues earned or the quantity of product produced or extracted. As each additional unit of product is produced or extracted, an additional obligation, usually a current liability, is created.

Customer Advances and Deposits

1. When **returnable deposits or customer advances** are received from customers or employees, a liability corresponding to the asset received is recorded. The classification of these items as current or non-current liabilities is dependent on the time involved between the date of the deposit and the termination of the relationship that required the deposit.

Taxes Payable

1. Current tax laws require most business enterprises to collect sales taxes from customers and income taxes from employees during the year and periodically remit these collections to the appropriate governmental unit. In such instances, the enterprise is acting as a collection agency for a third party. If tax amounts due to governmental units are on hand at the financial statement date, they are reported as current liabilities.
2. Sales Taxes Payable: To illustrate the collection and remittance of sales tax by a company, assume that Bentham Company recorded sales for the period of \$230,000. Further assume that Bentham is subject to a 7% sales tax collection that must be remitted to the provincial government. The entry to record the sales tax liability is:

Accounts Receivable	246,100	
Sales		230,000
Sales Tax Payable		16,100

When payment is made, the sales tax payable would be debited and cash could be credited.

3. **Goods and Services Tax:** Most businesses in Canada are subject to a goods and services tax (GST). Because companies are permitted to offset the recoverable and payable amounts, only the net balance of the two accounts is reported on the statement of financial position. Until net credit balances are remitted to the Canada Revenue Agency, they are reported as current liability. A net debit balance is reported as a current asset. In the provinces with a Harmonized Sales Tax (HST), the full HST amount is treated the same as shown for the GST.
4. **Income Taxes Payable:** A corporation should estimate and record the amount of income tax liability as computed per its income tax return. Chapter 18 discusses in detail the complexities involved in accounting for the difference between taxable income under the tax laws and accounting income under generally accepted accounting principles.

Employee-Related Liabilities

1. Amounts owed to employees for salaries or wages of an accounting period are reported as a current liability. The following items are related to employee compensation and are often reported as current liabilities:
 - a. Payroll deduction.
 - b. Short-term compensated absences.
 - c. Profit-sharing and bonuses.
2. The following illustrates the concept of accrued liabilities related to payroll deductions. Assume a weekly payroll of \$10,000 that is entirely subject to Canada Pension (4.95%) and Employment Insurance (1.83%) deductions. Also, income tax withholding amounts to \$1,320, and union dues to \$88. Two entries are necessary to record the payroll, the first for the wages paid to employees and the second for the employer's payroll taxes. The two entries are as follows:

Wages and Salaries	10,000.00	
Employee Income Taxes Payable		1,320.00
CPP Contributions Payable		495.00
EI Premiums Payable		183.00
Union Dues Payable		88.00
Cash		7,914.00
Payroll Tax Expense	751.20	
CPP Contributions Payable (\$495 x 1.0)		495.00
EI Premiums Payable (\$183 x 1.4)		256.20

3. **Compensated absences** are absences from employment, such as vacation, illness, maternity, paternity, and holidays, for which it is expected that employees will be paid. In connection with compensated absences, **vested rights** exist when an employer has an obligation to make payment to an employee even if that employee terminates. **Accumulated rights** are those rights that can be carried forward to future periods if not used in the period in which earned. **Accumulated rights** that are not vested, but can be carried forward to future periods, must also be recorded. However, the accrued amount can be adjusted for estimated forfeitures due to turnover. **Non-accumulating rights** are those to which employees are entitled if a specific event occurs, such as parental leave or short-term disability. As a result, no accrual is recorded, and the company only recognizes an expense when the obligating event occurs (the **event accrual method**).
4. The expense and related liability for compensated absences should be recognized in the year in which they are earned by the employees, whenever a reasonable estimate can be made of the amounts expected to be paid out in the future. To determine the cost of compensated absences, companies are more likely to use the current wage rate rather than a future rate, which is less certain and raises issues concerning the discounting of the future amount.
5. The accounting and reporting standards for post-retirement benefit payments are complex and are discussed extensively in Chapter 19.
6. An obligation under a profit-sharing or bonus plan must be accounted for as an expense and not a distribution of profit, since it results from employee service and not a transaction with owners. **Bonus agreements and profit-sharing plans** are common incentives established by companies for certain key executives or employees, though they may be open to all employees. In many cases, the payment is dependent upon the amount of income earned by the company. However, because the payment is a compensation expense deducted in determining net income, it must be deducted before net income can be computed. Thus, we end up with the need to solve an algebraic formula to compute the bonus. In addition, when the concept of income taxes is added to the formula, calculation of the bonus requires solving simultaneous equations.

NON-FINANCIAL LIABILITIES

Decommissioning and Restoration Obligations ***Asset Retirement Obligations***

1. In industries such as mining or oil drilling, the construction and operation of long-lived assets often involves obligations at the time of retirement of those assets. A company must recognize an **asset retirement obligation (ARO)**, an existing legal obligation associated with the retirement of a tangible long-lived asset that results from its acquisition, construction, development, or normal operation in the **period in which it is incurred, if its fair value can be reasonably estimated**. If a fair value cannot be reasonably estimated, the details must be reported in the notes.
2. **Obligating Event.** Existing legal obligation that requires the recognition of a liability and asset cost such as the cost of restoring or reclaiming oil and gas properties.
3. **Measurement.** Under the *CICA Handbook*, Part II (ASPE), Section 3110.09, an ARO is initially measured at the best estimate of the expenditure required to settle the present obligation at the reporting date, which is similar to the proposed revision.
4. **Recognition and Allocation.** The estimated costs of the ARO are included in the carrying amount of the related long-lived asset in the same amount as the liability recognized. An asset retirement cost is recorded as part of the related asset because these costs are considered a cost of operating the asset. Therefore, the specific asset, e.g., mine, drilling platform, nuclear power plant, should be increased and should not be recorded as a separate account. The ARO is amortized to expense over the related asset's useful life. Because the liability is measured on a discounted basis, interest on the liability is recognized each period as an increase in the carrying amount of the liability and either an accretion expense (ASPE, operating cost) or an interest expense (IFRS, interest or borrowing cost). Subsequent changes in the ARO due to production are added to the asset's capital cost under ASPE and inventoried under IFRS.
5. **Reporting and Disclosure Requirements.** Most of the AROs are long-term in nature and should be shown outside current liabilities, providing details of the AROs and associated long-lived assets.

Unearned Revenues

1. A company sometimes receives cash in advance of the performance of services or issuance of merchandise. Such transactions result in a credit to a deferred or unearned revenue account classified as a current liability on the statement of financial position. As claims of this nature are redeemed, the liability is reduced and a revenue account is credited.

Product Guarantees and Customer Programs

Warranties

1. A **warranty** (product guarantee) represents a promise by a seller to a buyer to make good on any deficiency in quantity, quality, or performance specifications in a product. Product warranty costs may be accounted for by using the **cash basis method** or the **accrual method**. The cash basis method must be used for income tax purposes and for financial accounting purposes when a reasonable estimate of warranty costs cannot be made at the time of sale. The accrual method includes two different accounting treatments: **a) expense warranty approach**, and **b) revenue warranty approach**.
2. The expense warranty treatment should be used whenever the warranty is an integral and inseparable part of the sale and is viewed as a loss contingency. Under the expense warranty approach the liability is measured at the estimated cost of meeting the obligation and recorded in the period of the sale. There is no effect on future income if the estimated and actual costs are close. Warranty expense is recorded in the year in which the item subject to the warranty is sold. When the warranty is honoured in a subsequent period the liability is reduced by the amount of the expenditure to repair the item. For example, if 200 units are sold for \$5,000 each and the estimated warranty cost is \$300 per unit, the following entry would be made for the sale and the warranty:

Cash (\$5,000 x 200)	1,000,000	
Sales		1,000,000
Warranty Expense	60,000	
Estimated Liability Under Warranty		60,000

Actual expenditures made to honour the warranty would debit the liability account and credit cash.

- The revenue warranty treatment defers a certain amount of the original sales price until some future time when actual costs are incurred or the warranty expires. Under the revenue approach, the liability is recognized as an unearned revenue amount and is measured at the value of the service to be provided, not at its cost. For instance, assume the same basics as above, but warranty agreements for a two year period similar to this are available separately and have a separate value of \$350 each. In this case, the company would allocate \$350 of each “bundled” sale to the warranty contract. The entry to record the sale would be as follows:

Cash (\$5,000 x 200)	1,000,000	
Unearned Warranty Revenue (\$350 x 200)		70,000
Sales		930,000

Over the two years, the unearned warranty revenue will be recognized as earned warranty revenue.

Premiums, Coupons, Rebates, and Loyalty Programs

- If a company offers premiums to customers in return for coupons, a liability should normally be recognized at year-end for outstanding premium offers expected to be redeemed. The liability should be recorded along with a charge to a premium expense account. The premiums, coupon offers, air miles, rebates, and prizes are made to stimulate sales, and their costs should be charged to expense in the period that benefits from the premium plan, i.e., the period of the sale. The cost of outstanding promotional offers that will be presented for redemption must be estimated in order to reflect the existing current liability and to match costs with revenues.
- Customer loyalty programs where customer loyalty credits are awarded are considered revenue arrangements with multiple deliverables. Under IFRS, IFRIC Interpretation 13 *Customer Loyalty Programmes* specifically identifies that the revenue from the original transaction is to be allocated between the award credits and the other components of the sale with the fair value of the award credits recognized as unearned revenue, a liability account. ASPE does not specifically address this but its general principles of revenue recognition would result in similar treatment.

Contingencies and Uncertain Commitments

1. A contingency is an existing or possible condition or situation involving uncertainty as to possible gain (gain contingency) or loss (loss contingency) to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur that will confirm their existence or amount payable.

Contingent gains are not recognized under ASPE. Under IFRS, a potential reimbursement is only recognized when recovery is certain, and under the proposed new standards the right to reimbursement is recognized only if it can be reliably measured.

2. Under current standards, some **contingent liabilities** may not be recognized at all, some are recognized in the accounts, and some only as note disclosures. Whether a liability should be recognized depends on the likelihood that a future event or events will confirm the contingency exists. Under ASPE, the range used to assess this is **likely, unlikely, or not determinable**.
3. An estimated loss from a loss contingency should be accrued by a charge to expense and a liability recorded only if both the following conditions are met:
 - a. Information available prior to the issuance of the financial statements indicates that it is likely that a future event will confirm that an asset has been impaired or a liability incurred as of the date of the financial statements, and
 - b. The amount of the loss can be reasonably estimated.

Neither the exact payee nor the exact date payable need be known to record a liability. **What must be known is whether it is likely that a liability has been incurred.**

4. Under current IFRS, the term “contingent liability” refers only to those existing or possible obligations that are not recognized. An obligation considered a contingent liability under ASPE would be called just a liability under IFRS. The approach to recognizing the liability under IFRS is similar to ASPE. However, new standards being proposed would require an entity to determine whether an unconditional obligation exists at the reporting date before recognizing the liability. If the unconditional obligation exists, it must be recorded and the uncertainty relative to future events is taken into consideration when measuring the liability being recorded.

Litigation, Claims, and Assessments

1. Companies generally only report one current and one non-current amount for provisions in the statement of financial position. IFRS requires extensive disclosure related to provisions in the notes to the financial statements. When a company is threatened by legal action (**litigation, claims, and assessments**), the recording of a liability will depend upon certain factors. Among the more

prevalent are (a) the **time period** in which the underlying cause for action occurred (i.e., the cause for litigation must have occurred on or before the date of the financial statements), (b) the **probability** of an unfavourable outcome, and (c) the ability to make a **reasonable estimate** of the amount of loss. However, even if the evidence does not favour a company, it will not publish a dollar estimate of the probable negative outcome as it would weaken their position. So, companies provide a general provision for the costs expected to be incurred with relating the disclosure to any specific lawsuit or set of lawsuits.

Financial Guarantees

1. Financial guarantees are commonly those where one entity (the guarantor) contracts that it will pay the holder of a debt if another entity (the debtor) fails to meet its obligations. Financial guarantees meet the definition of a financial liability. ASPE requires treatment for financial guarantees that are similar to loss contingencies. Under IFRS, the guarantee is recognized initially at fair value and subsequently at the higher of the best estimate of the payments that would be needed to settle the obligation at the reporting date and any unamortized premium received as a fee for the guarantee (unearned revenue).

Commitments

1. Executory contracts are contracts where neither party has yet performed and are not included in the definition of non-financial liability. Contractual obligations and contractual commitments arise as a result of agreements with customers, suppliers, employees and other parties. Disclosure is only required of significant commitments – i.e., those that involve significant future resources, are abnormal relative to the company's financial position and usual operations, or involve significant risk.

Presentation, Disclosure, and Analysis

1. **Current liabilities** are usually recorded and reported in the financial statements at their full maturity value. Present value techniques are not normally used in measuring current liabilities, because of the short time periods involved and the maturity value is generally not large. Current liabilities are normally listed at the beginning of the liabilities and shareholders' equity section of the statement of financial position. Within the current liability section the accounts may be listed in order of maturity, in descending order of amount, or in order of liquidation preference.
2. **Contingencies, Guarantees, and Commitments** are disclosed if:
 - it is likely that a future event will confirm the existence of a loss but the loss cannot be reasonably estimated.
 - a loss has been recognized, but there is an exposure to loss that is higher than the amount that was recorded.
 - it is not possible to determine the likelihood of there being a future event that confirms the liability.
3. Companies reporting under ASPE are also required to report **contractual commitments** that are significant relative to their current financial position of future operations. Guarantors must report information about any guarantees they have made even if it is not likely they will be required to make any payments.
4. Disclosure information should be sufficient to meet the requirement of full disclosure. Companies should clearly identify secured liabilities, as well as indicate the related assets pledged as collateral. If the due date of any liability can be extended, a company should disclose the details. Companies should not offset current liabilities against assets that it will apply to their liquidation. Finally, current maturities of long-term debt should be classified as current liabilities.

Analysis

1. Analysts are interested in the **liquidity of a company**. Part of this analysis requires an assessment of the ability to pay current obligations as they come due. These obligations arise from both financing activities (such as notes payable) and operations (such as accounts and salaries payable). Ratios that focus on current liabilities in this analysis include the **current ratio**, the **acid-test ratio**, and the **days payables outstanding** ratio.

IFRS and ASPE

1. Accounting for non-financial liabilities, including contingencies, is still in a state of transition. Text **Illustration 13-15** identifies the current differences between IFRS and ASPE in addition to an indication of what is expected in the revised IFRS on *Liabilities* that will replace IAS 37 *Provisions, Contingent Liabilities, and Contingent Assets*.