

Chapter 9: Reporting and Interpreting Current Liabilities

LIABILITIES DEFINED AND CLASSIFIED

The Statement of Financial Position (hereafter, SFP) provides data on the value of a company's assets and the extent to which they are debt-financed (i.e., liabilities) or owned (i.e., shareholders' equity). "*Capital structure* is the mixture of debt and equity that finances the short-and long-term operating requirements of a company."¹ "In deciding how best to finance its projects, (...) management must consider two key factors: the financial risk associated with the source of financing and the cost." Debt-financing is riskier than equity-financing. Debt represents a fixed obligation for the borrower. The borrower is required to make regular principal and interest payment(s) to the creditor. Equity does not create a fixed obligation for a company, since dividend payments are not mandatory. Bearing these points in mind, highly leveraged firms are more prone to cash-flow problems to the extent they are obliged to make fixed principal and interest payments to creditors.

The focus of the chapter is on the accounting for liabilities. "*Liabilities* are present debts or obligations arising from an entity's past transactions that will be paid with assets or services." A liability is recognized on the SFP for an amount equal to the current cash equivalent the creditor would accept to settle the liability immediately. "*Current liabilities* are short-term obligations that will be settled within the coming year (or the operating cycle, whichever is longer) by providing cash, goods, or other current services." The value of short-term debt tends to be "...based on contractual agreements between the company and suppliers of goods, services, or funds." In contrast, the value of long-term debt is recognized for an amount equal to the present value of future cash outflows needed to settle the debt. (The discussion below delves into the time-value of money.)

Companies struggling to satisfy current obligations have liquidity problems. ("*Liquidity* is the ability to pay current obligations.") Suppliers are less likely to extend credit to any company that is more likely to default on satisfying its current obligations. Any company that cannot secure credit from suppliers must borrow money from the bank to pay for routine operating purchases, and the bank charges a considerable amount of interest that erodes profits. Further investors and analysts are less likely to view a company favorably if liquidity problems are apparent. Analysts use a couple of ratios to evaluate the strength of a company's working capital, and these ratios are the quick ratio and the current ratio. (Refer to page 495 of the text.) "*Working capital* is a margin of safety indicating that a company can meet its short-term obligations." Maintaining healthy working capital is tricky; it involves finding an appropriate point of balance between satisfying short-term obligations and maximizing the use of organizational resources. As an example, every organization needs to ensure sufficient inventory is on hand to satisfy customer demand, whilst minimizing inventory storage costs.

It is important to make a distinction between current liabilities and non-current liabilities, given they have a different impact on a company's future cash flows and overall risk exposure. To illustrate this point, current liabilities are settled by cash (or, if need be, by disposing of highly liquid assets) as compared to non-current liabilities that are settled by cash-flows generated by capital assets. Liabilities are listed on the SFP in terms of their time-to-maturity. "Current liabilities are (also) usually grouped according to type of creditor, separating liabilities owned to trade suppliers and other creditors (accounts payable) from those owned to providers of services (accrued liabilities), customers (deferred revenue), banks (short-term borrowings), governments (taxes payable), and others."

Many current liabilities are born from observable transactions, though, other ones are recognized at period-end due to the passage of time (i.e., accruals). The value of some accruals, like accrued salaries payable and accrued interest payable, are easy to determine. Determining the value of other types of accruals, on the other hand, is more challenging. The precise value of accruals, like ones for product warranties for instance, are based on future events (or non-events) and anything that may (or may not) happen in the future creates a degree of uncertainty. Nevertheless, all accruals need to be recognized in the current period in an application of the matching principle.

CURRENT LIABILITIES

Current liabilities are generally used to finance operating activities in contrast to long-term debt that is used to acquire non-current assets, like property, plant and equipment.

¹ Direct excerpt from the 6th edition of the text. All quoted material comes from the text. Please consult the instructor for more specific citation information.

Accounts Payable

Companies typically purchase goods and services from other businesses on open account. These purchases give rise to accounts payable (or more specifically, trades payable) and these short-term debts are settled shortly thereafter via cash payment. Typically credit terms are offered to companies purchasing items on account, and the purpose of these credit terms is to incentivize early debt settlement. Interest is rarely charged on accounts/trade payable – provided they are settled before their due date. Management may be tempted to postpone settling particular accounts payable if money can be invested elsewhere to generate a relatively higher return. This type of opportunistic behavior is undesirable however. It can alienate a company from its suppliers. Moreover “old” payables reflect poorly on specific ratios, like the trade payables turnover ratio and the average age of payables ratio. These ratios are carefully scrutinized by analysts and investors, who, may in turn, decide against allocating capital to a company unable to settle its current payables.

Accrued Liabilities

“*Accrued liabilities* are expenses that have been incurred but have not been paid at the end of the accounting period.” The liability and the associated expense is recognized via an adjusting entry at the end of the accounting period. The analysis now turns to the accounting for 4 types of accrued liabilities.

(1) Income Taxes Payable

Canadian corporations pay corporate income tax to the Canada Revenue Agency (hereafter, CRA) and the appropriate provincial tax body. The combined corporate income tax rate (i.e., combined federal and provincial income tax rate) lies between 30% and 35% in Canada. “Generally, corporations have to pay their taxes in instalments. The balance of tax is paid two or three months after the end of the tax year depending on (the corporation’s) balance-due day.”² A corporate income tax return is called a “T2” in practice. Income tax expense is calculated at year-end for accounting purposes and it is a function of Earnings before Income Tax (EBIT). An adjusting entry is made at year end, whereby the tax rate is multiplied by EBIT to determine income tax expense and the associated liability. Income tax expense is split into two amounts on the Statement of Earnings (hereafter, S/E): (1) current income tax expense and (2) deferred income tax expense. (Refer to the illustration on page 499.) The distinction between them relates to differences between financial accounting and corporate income tax (discussed shortly).

Accounting for income taxes is a complicated topic covered more extensively in ACCO 320. One reason it is complex is that different rules are applied for the purposes of financial reporting and for the purposes of applying the Income Tax Act. A company will rarely report an amount of income tax expense on the S/E equal to the amount of income tax remitted to the government as a result of discrepancies between the rules underpinning financial reporting and the Income Tax Act. At the risk of oversimplification, financial accounting (i.e., IFRS and ASPE) turns on accrual accounting, whereas corporate income tax (with certain, specific exceptions) focuses on cash transactions. Application of these different frameworks gives rise to temporary differences and permanent differences regarding the recognition of specific revenues and expenses. Two examples of permanent differences can be seen in the treatment of golf club dues and meals and entertainment costs. Golf club dues (in their entirety) are deducted from revenue on the S/E; golf club dues are not a permissible tax deduction on a T2. Meals and entertainment costs are deducted in their entirety from revenue on the S/E; only 50% of meals and entertainment-related costs are a permissible tax deduction on a T2.

On the other hand, temporary differences arise between revenues and expenses recognized for the purposes of financial reporting and corporate income tax, respectively. Temporary differences manifest, for instance, to the extent revenues and expenses are recognized at different points in time for accounting and tax purposes. As an example, revenue is recognized on the S/E when it earned. In contrast, revenue is recognized on a T2 when cash is received, irrespective of whether any revenue is earned. To illustrate this point, a company might earn revenue of \$2 million in 2025 and collect the associated cash in 2026. It records revenue of \$2 million on the S/E in 2025. It does not report the \$2 million revenue on the 2025 T2; a \$2 million revenue is reported on the 2026 T2 though. The

² Retrieved from <https://www.canada.ca/en/revenue-agency/services/tax/businesses/topics/corporations/corporation-payments.html> on October 23, 2017.

difference regarding the recognition of the \$2 million revenue is temporary because the discrepancy is eliminated by 2026, at which point the \$2 million revenue is recognized for both accounting and tax purposes.

Temporary differences give rise to the recognition of deferred income tax assets and deferred income tax liabilities on the SFP. The previous example creates a deferred income tax liability, being as the company must pay tax on the \$2 million revenue next year (i.e., 2026) even though, for accounting purposes, it has already earned the revenue in 2025. A deferred income tax asset is recognized on the SFP when deferred revenue is recognized, in which case a company pays tax on money collected in the current period even though the associated revenue is not recognized for accounting purposes until a future period. The topic of accounting for income taxes is a very complex subject covered in ACCO 320. Please limit your consideration of this topic to material covered in these notes, chapter 9, and Appendix 9A.

(2) Taxes Other Than Income Taxes

Companies collect federal Goods and Services Tax (“GST”, 5%), Provincial Sales Tax (“PST”, 0% - 10%) and/or Harmonized Sales Tax (HST) when they sell things to customers. GST, PST, and HST are calculated as a percentage of sales. A Company must remit these tax amounts collected to the appropriate tax authorities, and this generally happens on a quarterly basis, whereby a company is permitted to deduct GST/PST/HST paid on operating expenses from GST/PST/HST collected from customers. The net difference is remitted to the government, though, it is possible for a company to claim a GST, PST, or HST rebate if it pays more GST, PST, or HST than it collects from customers. Any GST, PST, or HST collected from customers is recognized as a liability (e.g., GST payable, PST payable, HST payable) on the SFP. An adjusting entry is often made at period-end to update this liability’s value.

(3) Payroll Liabilities

Companies pay their employees. Employees, in turn, pay income tax on earnings to federal and provincial tax authorities. Companies, though, deduct income tax from employees’ gross earnings every time payroll runs. Companies eventually remit tax deducted from employee salaries/wages to the government. Payroll deductions are a liability on the SFP until the company pays cash to the government. You will recall unpaid salaries are accrued at year-end. An accrual is also made to recognize liabilities associated with income tax deductions on earned (but unpaid) salaries at year-end. Income tax is not the only payroll deduction. Deductions are also made to subsidize retirement programs, vacation time, pensions, health insurance, and so forth. These deductions are also reported as liabilities on a company’s SFP until a cash payment is made to the appropriate party (e.g., pension plan administrator, financial institution, etc). Employers often match employee contributions to benefit plans, like pension plans. Any contribution made by the employer is treated as a part of compensation expense on the S/E. A liability is recognized, in this case, until the employer makes a cash contribution to pension plan. Employee contributions (i.e., deducted from their paycheck) never impact compensation expense. Employee pension deductions are treated as liabilities on the SFP until cash is paid to the financial institution presiding over the pension plan.

(4) Additional Employee Deductions

Additional deductions are made from employees’ paychecks, including deductions for Employment Insurance (EI) and Canada Pension Plan (CPP) [or Quebec Pension Plan in the province of Quebec]. Generally, a company matches its employees’ CPP contributions and pays \$1.40 to the CRA for every dollar its employees contribute to EI. These deductions also represent a liability prior to remittance. Adjusting entries are needed to recognize any CPP or EI payable on any unpaid (but earned) salaries at year-end. Employer contributions are accounted for as a type of compensation expense. (Refer to pages 500 and 501 for details on how to prepare these journal entries.)

Notes Payable

You will recall a note payable is a formal written contract specifying “...the amount borrowed, the date by which it must be paid, and the interest rate associated with the borrowing.” A long-term note is due beyond a company’s current operating cycle. Often a long-term note is settled several years in the future. A creditor is willing to lend money to a company provided the creditor is reimbursed for the value of using the money over time (i.e., time value of money). Borrowers pay interest on long-term debt to compensate creditors for the time-value of borrowed money.

“To the borrower, interest is an expense; to the creditor, interest is revenue.” Use this formula to calculate interest: Interest = Principal x Annual interest rate x Time. Note: principal is the amount of money borrowed; time is generally some fraction of 12 months although time can be 1; annual interest rate = contractually specified rate.

Here’s an example to illustrate how the accounting for a note payable works. Assume Michael Corp. borrows \$100,000 by signing a 5-year note; the note is due in its entirety at the end of five years; the note is dated September 1, 2025 and it matures on September 1, 2030; the note’s annual interest rate is 6%; interest is due each year on the same date the note was originally signed; Michael Corp. has a December 31-year end. This journal entry is prepared by Michael Corp. on September 1, 2025:

<i>Cash</i>	<i>\$100,000</i>	
<i>Note Payable</i>		<i>\$100,000</i>

This journal entry is prepared by Michael Corp on December 31, 2025:

<i>Interest expense (\$100,000 x 6% x 4/12)</i>	<i>\$2,000</i>	
<i>Interest payable</i>		<i>\$2,000</i>

This journal entry is prepared by Michael Corp. on September 1, 2026:

<i>Interest expense (\$100,000 x 6% x 8/12)</i>	<i>\$4,000</i>	
<i>Interest payable</i>	<i>2,000</i>	
<i>Cash</i>		<i>\$6,000</i>

This journal entry is prepared by Michael Corp. on September 1, 2030:

<i>Interest expense (\$100,000 x 6% x 8/12)</i>	<i>\$4,000</i>	
<i>Interest payable</i>	<i>2,000</i>	
<i>Note Payable</i>	<i>100,000</i>	
<i>Cash</i>		<i>\$106,000</i>

Please refer to Appendix 9B for a more comprehensive discussion on present value concepts. The present value concept is tied to the time-value of money concept. Here’s a short summary of the appendix’s highlights:

“*Present value* is the current cash equivalent of an amount to be received in the future, or a future amount discounted for compound interest.” Long-term debt is measured at an amount equal to the present value of future cash flows. Future cash flows must be discounted to determine a present value figure since a dollar today is worth more than a dollar tomorrow (i.e., you can invest a dollar today and then earn interest over the course of 1 year but you can’t earn any interest over the next 1 year if you don’t have the dollar until the end of the year). In sum, any future cash-flows need to be discounted to determine their present value. This logic applies to determining the present value of long-term debt. A company recognizes long-term debt as the summation of the present value of future interest payments and principal payments. Debt can mature as a single lump-sum amount. The value of this debt is recognized as an amount equal to the future lump-sum amount discounted by the applicable rate (i.e., present value of a single amount). In other cases, borrowers make regular principal and interest payments to settle long-term debt. Sometimes equal payments are made over the life of a debt instrument. “An *annuity* is a series of equal amounts of cash that are paid (i.e., by the borrower) or received (i.e., by the creditor) at equally distant points in time.” The present value of an annuity is the discounted value of the regular and equal payment the borrower makes to the creditor. (Refer to Appendix 9B for details on how to calculate the present value of single amount and an annuity.)

Current Portion of Long-Term Debt

Long-term debt is a non-current liability on the SFP. Long-term debt matures several years in the future. Eventually, though, a portion of (or all of) a specific long-term debt becomes due in the next year. This portion is reclassified as a current liability on the SFP and it is known as the current portion of long-term debt. Managers and investors value

this information, in part because it better enables them to determine whether a company has enough current assets to satisfy its short-term obligations.

Deferred Revenues

“*Deferred revenues* are previously recorded liabilities that need to be adjusted at the end of the accounting period to reflect the amount of revenues earned.” You will recall a company recognizes deferred revenue whenever it collects cash before delivering the associated goods or services. Gift cards and other prepaid cards give rise to deferred revenue. Deferred revenue is recognized as revenue as the company delivers goods and services to customers. To illustrate this point, companies sell extended warranties on big ticket items to customers. This journal entry is prepared when an extended warranty is sold:

<i>Cash</i>	<i>xxx</i>	
<i>Deferred extended warranty revenue</i>		<i>xxx</i>

Revenue is gradually recognized over the duration of the extended warranty period or as repair work is completed. The following journal entry is prepared when a portion of warranty revenue is earned:

<i>Deferred extended warranty revenue</i>	<i>xxx</i>	
<i>Revenue from extended warranties</i>		<i>xxx</i>

Provisions Reported on the Statement of Financial Position

“A *provision* is a liability of uncertain timing or amount.” That is, the amount of the liability or the timing of the liability is uncertain right now. “A provision must be recognized when the following conditions are met: (1) an entity has a present obligation as a result of a past event, (2) it is probable that cash or other assets will be required to settle the obligation, and (3) a reliable estimate can be made of the amount of the obligation.” Warranties give rise to a provision on the SFP (provided the above three conditions are satisfied). Companies are required to provide significant disclosure on provisions in the notes accompanying the financial statements. Disclosures on warranties, for instance, expound things like the basis for determining the value of the warranty, future estimated warranty costs, and assumptions made to calculate said costs. Other provisions are made for product returns and allowances, production restructuring initiatives, and so on.

CONTINGENT LIABILITIES AND COMMITMENTS

“A *contingent liability* is a possible liability that is created as a result of a past event; it is not an effective liability until some future event occurs.” Contingent liabilities can arise in the context of pending lawsuits, environmental problems, and tax disputes. A contingent liability is recognized on the SFP when the value of the future obligation can be measured reliably and there is a reasonably high likelihood a past transaction has given rise to a future obligation. Contingent liabilities that are either improbable or cannot be estimated with sufficient reliability are not recognized on the SFP, though, they must be disclosed in the notes accompanying the financial statements. Notes delve into the nature and timing of the future obligation regardless of whether a contingent liability is recognized on the SFP. “*Commitments* (on the other hand) reflect contractual agreements to enter into transactions with other parties.” Commitments are not recognized for accounting purposes in the absence of an exchange transaction.

WORKING CAPITAL MANAGEMENT

“Working capital is the difference between current assets and current liabilities.” Working capital is routinely evaluated by management and investors as a proxy for a company’s health. Companies with deficiencies in working capital regularly face liquidity problems. In contrast, companies carrying an overabundance of current assets tie up precious resources that could otherwise be put to better use. Excessive inventory, for instance, increases storage costs and by extension reduces profits.