

Chapter 10- Reporting and Analyzing Liabilities

Liabilities

Liabilities are present obligations that result from past transactions. We distinguish between:

1. Current Liabilities

- Debt that will be paid within one year from:
 - Existing current assets (cash)
 - Through the creation of other current liabilities (note payable)

2. Non-current Liabilities

- Debts that do not meet both the aforementioned criteria
- Example: instalment notes payable and bonds payable

Current Liabilities

- Types of current liabilities
 - Bank indebtedness
 - Accounts payable
 - Accrued liabilities (taxes, salaries, interest,...)
 - Unearned Revenue
 - Notes or loans payable
 - Current portion of non-current debt

Operating line of credit

- pre-authorization by the bank that allows companies to borrow money up to a pre-set limit, when it is needed.
- Interest is usually charged at a **floating (variable)** interest rate on any amounts used from the line of credit.
- Security, called **collateral**, is usually required by the bank as protection in the event of default on the loan.
- A **bank indebtedness** is a negative or credit bank balance (debit to the bank) which is reported as a current liability on the statement of financial position.
- *No special journal entry is required to record an overdrawn amount.*

Sales Taxes

1. Federal Goods and Services Tax (GST)
 2. Provincial Sales Tax (PST or QST)
 3. Combined into one harmonized sales tax (HST) in some provinces
- The retailer collects the sales tax from the customer when the sale occurs and remits the tax to the federal and provincial collecting authorities (usually monthly).
 - In the case of GST and HST, collections may be offset against payments (i.e. sales tax payments made by the company on its own eligible purchases). Only the net amount owing or recoverable will be paid or refunded.

Example

Sales of \$6,000 on October 1

- record the sales assuming they occurred in ON and are subject to 13% HST (charged on selling prices only)
- Record the sales assuming they occurred in QC and are subject to 5% GST and 9.975% HST (charged to selling price before GST)

Cash 6,780 (6,00+780) **(6,000x0.13=780)**

Sales	6,000	
Sales Tax Payable	780	

Cash (6,000+899) 6,899

Sales	6,000	
Sale Tax Payable (6,000 x 5%)+ (6,000 x 9.975)	899	

Property Taxes

- Taxes are charged by the municipal and provincial governments and are calculated at a specified rate for every \$100 of the assessed value of the property (i.e. land and building).
- Paid annually.
- are generally for the calendar year, though bills are not usually issued until the spring.

JOURNAL ENTRIES

1. at reception of the bill, record the expense for the period that has already passed

Dr. Property tax expense	
Cr. Property tax payable	

2. at payment of the bill, record the payment of the expense and the prepayments.

Dr. Property tax payable	
Dr. Property tax expense	
Dr. prepaid property tax	
Cr. Cash	

3. at year end, adjust the prepaid tax.

Dr. property tax expense	
Cr. prepaid property tax	

Example

Company has a December 31 year end. Property tax assessment of \$36,000 for the calendar year on April 30. The property tax bill is payable on July 15. Prepare the journal entry to record property tax on

- April 30
- July 15
- December 31 (assuming the company adjusts its accounts annually)

36,000/12
= 3,000 per month

- April 30

Property Tax Expense (3,000 x 4)	12,000	
Property Tax Payable		12,000

- July 15

Property Tax Payable	12,000	
Property Tax Expense (3,000 x 2.5)	7,500	
Prepaid Property Tax	16,500	(36,000-12,000-7,500)
Cash		36,000

- December 31

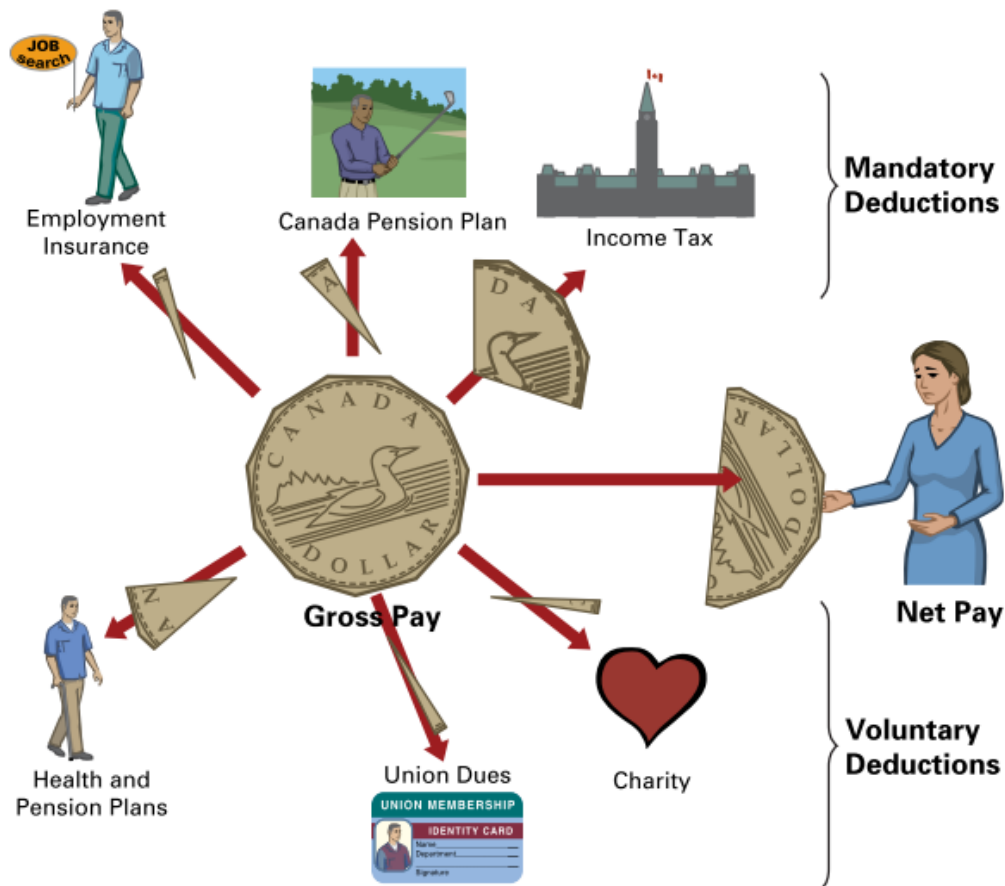
Property Tax Expense	16,500	
Prepaid Property Tax		16,500

Payroll

- Three types of liabilities related to employees' salaries or wages:
- (1) the net pay owed to employees
- (2) employee payroll deductions
- (3) employer payroll obligations

1. Net Pay

- Management personnel are normally paid **salaries**, which are expressed as a specific amount per week, per month, or per year.
- Part-time employees or employees paid on an hourly basis or by the work produced are normally paid **wages**.
- salaries + wages = **gross pay** or gross earnings.
- Gross pay - payroll deductions = **net pay**.



2. Employee Payroll Deductions

- Mandatory payroll deductions include amounts withheld for federal and provincial income taxes, Canadian Pension Plan (CPP) contributions, and Employment Insurance (EI) premiums.
- Voluntarily deductions for charitable, union, pension, and insurance contributions.

Dr. Salaries Expense
 Cr. Income Tax Payable
 Cr. CPP Payable
 Cr. EI Payable
 Cr. Cash

3. Employer Payroll Obligations

- Employers pay payroll costs such as the employer's share of CPP and EI. Also, they fund the worker's compensation plan. These costs are recorded as an employee benefits expense.

Dr. Employee Benefits Expense
 Cr. CPP Payable
 Cr. EI Payable

- Until these payroll deductions and costs are remitted to the third parties that they are collected for, they are reported as current liabilities.

Example

Company gross salaries for the biweekly period ended August 22 were \$15,000. Deductions included \$743 for CPP, \$267 for EI, and \$6,258 for income tax. The employer's payroll costs were 743 for CPP and 374 for EI

- for the payment of salaries on August 22

Salaries expense 15,000
 income tax payable 6258
 CPP payable 743
 EI payable 267
 Cash (15,000-6,258-743-267) 7,732

- employees payroll costs on Aug 22, assuming they will not be remitted to the government until September

Employee benefit expense 1,117
 CPP payable 743
 EI payable 374

- payment to the government on Sept 1 of all amounts owed

Income tax payable 6258
CPP payable 1486 (743 +743)
EI payable 641 (267+374)
Cash 8385 (6258+1486+641)

Short-term notes payable

- obligations in the form of written notes.
- often used instead of accounts payable because they give the lender written documentation of the obligation, which helps if legal remedies are needed to collect the debt.
- Notes and loans are sometimes used interchangeably.
- Notes payable are frequently issued to meet short-term financing needs and usually require the borrower to pay interest.
- Notes that are due for payment within one year are classified as current liabilities.
- Short-term notes can have a floating interest rate; however, it is more common for them to have a fixed interest rate.

JOURNAL ENTRIES

1. Record issue of note:

 Dr. Cash
 Cr. Notes payable

2. Record accrued interest

 Dr. Interest expense
 Cr. Interest payable

3. Record payment of note plus interest

Dr. Notes payable
Dr. Interest payable
Dr. Interest expense
Cr. Cash

Current maturities of non-current debt

- Current portion of a non-current debt should be included in Current Liabilities.
- A journal entry is not required to recognize this classification.

Example

Company borrowed \$60,000 from the bank on July 1 on three months, 5% interest is payable the first of each month, starting August 1. Companies year end is August 31

- the receipt of the bank loan on July 1

Cash 60,000
 Bank Loan Payable 60,000

- (1) the payment of interest on August 1

Intrest Expense 250 (60,000 X 5% X 1/12)
 Cash 250

- (2) the accrual of interest on August 31

Intrest Expense 250
 Intrest Payable 250

- (3) the payment of interest on September 1

Intrest Payable 250
 Cash 250

- (4) the payment of interest on October 1

Intrest Expense 250
 Cash 250

- Payment of the bank loan at maturity on October 1

Bank Loan Payable 60,000
 Cash 60,000

Financial Statement Presentation and Analysis of Liabilities

Current liabilities are the first category under liabilities on the statement of financial position.

- Each of the main types of current liabilities is listed separately within this category.
- Current liabilities are generally listed in their order of liquidity (by their due dates), but this is not always possible because of the varying maturity dates that may exist for specific obligations such as notes payable.
- Other orders are also possible (e.g., reverse-liquidity).
- Non-current liabilities are reported in a separate section of the statement of financial position immediately following current liabilities
- Summary data regarding debts may be presented on the SFP, while detailed data (such as interest rates, maturity dates, conversion privileges, and assets pledged as collateral) are usually shown in the notes to the financial statements.

Example

Total Current Assets: 1,748
Total Current Liabilities: 2,598.7
Total Assets: 16,212.2
Total Liabilities: 8,220.6
Income Tax Expense: 154.5
Interest Expense 185
Profit: 443

Calculate the

- Current Ratio
- Debt to total assets ratio
- Times interest earned ratio

Current Ratio: Current A/ Current L

$$1,748/2,598.7 = 0.67$$

Debt to Total Assets Ratio: Total L/Total A

$$8,220.6/16,212.2 = 0.51$$

Times Interest Earned Ratio: Profit/Interest Expense
=4.2

Analysis

Liquidity ratios measure the short-term ability of a company to pay its current obligations and to meet unexpected needs for cash.

- The **current ratio** (Current assets ÷ Current liabilities) is a commonly used measure of liquidity.

- The current ratio should be supplemented by other ratios such as **receivables turnover** and **inventory turnover**.

Solvency ratios measure the ability of a company to repay its long-term debt and survive over a long period of time.

- **Debt to total assets**

- =total liabilities/total assets.

- indicates the extent to which a company's assets are financed by debt.

- **Times interest earned**

- gives an indication of a company's ability to meet interest payments as they come due.

- Times interest earned=(profit + interest expense + income tax expense)/ interest expense
= profit before interest expense and income tax expense/interest