## Intermediate accounting – volume ii

## *CPA CANADA HANDBOOK*

## Introduction and Overview:

## The CPA CANADA Handbook is comprised of the following:

## Part I

## Accounting, Part I

International Financial Reporting Standards (IFRS)

## Part II

## Accounting, Part II

Accounting Standards for Private Enterprises (ASPE)

## Part III

## Accounting, Part III

Accounting Standards for Not-for-profit organizations

## Part IV

## Accounting, Part IV

Accounting Standards for Pension Plans

## Note that the focus of this text is on the first two parts. Part II is commonly referred to as Accounting Standards for Private Enterprises (ASPE).

Both ASPE and IFRS were required for year-ends beginning on or after 2011. A private enterprise is one that has not issued, and is not in the process of issuing, debt or equity instruments that are, or will be, outstanding and traded on a public market. A private enterprise does not hold assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses.

# CHAPTER 13

# NON-FINANCIAL AND CURRENT LIABILITIES

## CHAPTER TOPICS CROSS-REFERENCED WITH THE

## *CPA Canada HANDBOOK*, Part I (IFRS) AND Part II (ASPE)

|  |  |  |
| --- | --- | --- |
| Cash and Cash Equivalents | Section 1540 | IAS 7 |
|  |  |  |
| Current Assets and Current Liabilities | Section 1510 | IAS 1 |
|  |  |  |
| Non-financial liabilities | — | IAS 37 and IFRS 15 |
|  |  |  |
| Asset Retirement Obligations | Section 3110 | IAS 37 |
|  |  |  |
| Contractual Obligations | Section 3280 | IAS 37 |
|  |  |  |
| Contingencies | Section 3290 | IAS 37 |
|  |  |  |
| Financial Instruments—Recognition and Measurement | Section 3856 | IAS 39 |
|  |  |  |
| Financial Instruments—Presentation | Section 1521 | IAS 32 |
|  |  |  |
| Financial Instruments—Disclosure | Section 3856 | IFRS 7 |
|  |  |  |
| Disclosure of guarantees | AcG-14 | IAS 37 |
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## 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 product guarantees, other customer program obligations, and unearned revenues.

7. Explain and apply two approaches to the recognition of contingencies and uncertain commitments, and identify the accounting and reporting requirements for guarantees and commitments.

8. Indicate how non-financial and current liabilities are presented and analyzed.

9. 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 many common current liabilities and a variety of non-financial liabilities such as unearned revenue, product warranty and other customer obligations, and asset retirement obligations. It also addresses contingencies, commitments, and guarantees. Explanations regarding non-financial liabilities under international standards are based on current IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*

The IASB’s 2018 Conceptual Framework for Financial Reporting, among other things, provides clearer definitions of assets and liabilities, including more detailed guidance for interpreting the definitions.

The 2010 Exposure Draft of Proposed Amendments to IAS 37 Provisions, Contingent Liabilities and Contingent Assets suggested that the term “contingent liabilities” be eliminated. Under the proposed changes to IFRS, liabilities would arise only from unconditional (or non-contingent) obligations. Uncertainty about the amounts that might be payable are taken into account in the measurement of the liability, not its existence.

### Current Liabilities

2. Existing IFRS and ASPE state liabilities have three essential characteris­tics:

1. They embody a duty or responsibility to others.
2. The entity has little or no discretion to avoid the obligation to transfer a financial resource..(ASPE: transfr an asset or provide a service)
3. The transaction or other event creating the obligation has already occurred.

The three characteristics of a liability are essential to the current definition. First, a liability must represent a duty or responsibility; second, the entity has little (or no) discretion to avoid the obligation; and third; the liability relates to a transaction that has occurred (the goods were purchased, they have been delivered, and title has passed).

The obligations that liabilities represent may be legal obligations or **constructive obligations**. The latter are created by past performance or experience, or by unwritten promises relied upon by another party.

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 accounts payable, are accounted for at their maturity value since the difference between maturity value and fair value is usually 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.

Note that ASPE provides a similar definition.

#### Common Current Liabilities

#### *Bank Indebtedness and Credit Facilities*

7. 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*

8. **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.

Accounts payable arise because of the time lag between the receipt of goods and services and the payment; for example, 2/10, n/30 or 1/10, E.O.M., net 30. The period is commonly 30 to 60 days long.

### *Notes Payable*

9. **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.

10. Short-term notes payable resulting from borrowing funds from a lending institution may be **interest-bearing** or **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:

Cash 96,154

Note Payable 96,154

11. On June 30, when the note is paid, interest is also recorded as follows:

Interest Expense 3,846

Note Payable 96,154

Cash 100,000

12. The currently maturing portion of long-term debt 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.

13. 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:

* 1. the creditor waives the covenant (agreement) requirements, **or**
  2. the violation has been cured within the grace period that is usually given in these agreements, **and**
  3. 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***

14. 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*

15. **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*

16. **Rents** and **royalties** are contractual agreements covering 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*

17. 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*

18. 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 government units are on hand at the financial statement date, they are reported as current liabilities.

19. 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 Revenue 230,000

Sales Tax Payable 16,100

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

20. **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.

21. **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

22. Amounts owed to employees for salaries or wages of an accounting period are reported as current liabilities. The following items are related to employee compensation and are often reported as current liabilities:

a. Payroll deductions.

b. Short-term compensated absences.

c. Profit-sharing and bonuses.

23. 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 (1.88%) 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.

Wages and Salaries Expense 10,000.00

Employee Income Tax Deductions Payable 1,320.00

CPP Contributions Payable 495.00

EI Premiums Payable 188.00

Union Dues Payable 88.00

Cash 7,909.00

Employee Benefit Expense 758.20

CPP Contributions Payable ($ 495 x 1.0) 495.00

EI Premiums Payable ($ 188 x 1.4) 263.20

24. **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**).

25. 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.

26. The accounting and reporting standards for post-retirement benefit payments are complex and are discussed extensively in Chapter 19.

27.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*

28. 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.

29. **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. IFRS recognizes both legal and constructive obligations; ASPE recognizes legal obligations only.

30. **Measurement**. Under the *CPA Canada 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.

31. **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.

32. **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.

### *Product Guarantees, Customer Programs and Unearned Revenues*

33. 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. Warranties and product guarantees are stand-ready obligations at the reporting date that result in future costs that are often significant.

### 34.Businesses often offer continuing care or other customer programs that require them to provide goods and services after they have delivered the initial product or service. Historically an expense approach has been used to account for the outstanding liability, and this type of approach is still used for assurance-type warranties. More recently standards have moved to a revenue approach for warranties that are not included in the sales price of the product (that is, for service-type warranties).

**A overview of the two approaches:**

**Assurance-Type warranty**

35. Under IFRS 15, when the warranty is part of the sales price, the outstanding liability is measured at the cost of the economic resources needed to meet the obligation. This assurance-type warranty (expense-based approach) assumes that along with the liability that is required to be recognized at the reporting date, the associated expense needs to be measured and matched with the revenues of the period. In fact, the need to match expenses has driven this approach over the years. As the actual costs are incurred in subsequent periods, the liability is reduced. This type of approach has historically been used under ASPE.

**Service-Type Warranty**

36. Under IFRS 15, when the warranty is sold as an additional service beyond the assurance-type warranty, the outstanding liability is measured at the value of the obligation. It is an output price rather than an input price or cost measure. This is the situation when assets are received in advance for a variety of performance obligations to be delivered in the future. Under a service-type warranty (revenue-based approach), the proceeds received for any goods or services yet to be delivered or performed are unearned at the point of sale. Until the revenue is earned, the obligation-the liability- is reported at its sales or fair value. The liability is then reduced as the revenue is earned. Revenue recognition concerns are at the base of this approach. This parallels the contract-based approach to revenue recognition explained in Chapter 6 where the liability represents a performance obligation for insurance type warranties that are sold separately. Revenue is recognized when the service is provided and the performance obligation is satisfied. Under ASPE, this approach has been used increasingly with bundled sales to bifurcate them (or separate them).

There are two major differences between these approaches:

37. Under the expense approach for assurance-type warranties, the liability is measured at the estimated cost of meeting the obligation. Under the revenue approach for service-type warranties, the liability recognized is measured at the value of the service to be provided, not at its cost.

38. Under the expense approach, and assuming the estimate of the cost of the obligation to be met in the future is close to the actual future cost, there is no effect on future income. Under the revenue approach, future income is affected. Some amount of unearned revenue is recognized as a liability, and this is recognized as revenue in future periods when it is earned or the performance obligation is met. Any expenses associated with that revenue are also recognized in the future. Therefore, future income amounts are affected by the profit or loss earned on the delivery of the goods or services provided in subsequent periods.

IFRS 15 is clear about when the expense approach should be used (for assurance-type warranties) and when the revenue approach should be used (service-type warranties). Similarly, under ASPE the principle is that revenue that covers a variety of deliverables (bundled sales) should be unbundled and the revenue allocated to the various goods or services that are required to be performed. This method has been used increasingly over the past few years, while the expense approach tends to be used when the warranty is not a separate choice for the purchaser, but is included as part of the sales price.

### *Premiums, Coupons, Rebates, and Loyalty Programs*

39. Many companies offer premiums or other benefits to customers in return for box tops, coupons, labels, wrappers, or other evidence of having purchased a particular product. The premiums may be such items as silverware, dishes, small appliances, toys, or cash values against future purchases.

Printed coupons that can be redeemed for a cash discount on items purchased are extremely popular marketing tools, as is the cash rebate, which the buyer can obtain by returning the store receipt, a rebate coupon, and Universal Product Code (UPC label or bar code) to the manufacturer.

Contests have also been used to get consumers’ attention and their sales dollars.

With the life of many contests running a few months and the average coupon being valid for an average of approximately six months, many companies have the practical problem of accounting for these marketing costs, because they often affect more than one fiscal period. Historically, such programs have been accounted for under the expense approach. The accounting issue is that while these promotions increase current sales revenue, the associated costs are often incurred in future periods. The matching concept requires companies to deduct the total estimated costs against the current period’s revenue and the cost is charged to an expense account such as Premium or Promotion Expense. In addition, the obligations existing at the date of the statement of financial position must also be recognized and reported in a liability account such as Estimated Liability for Premiums or Estimated Liability for Coupons Outstanding.

40. Customer loyalty programs where customer loyalty credits are awarded are considered revenue arrangements with multiple deliverables. IFRS initially addressed this via IFRIC Interpretation 13 *Customer Loyalty Programmes, which has been superseded by IFRS 15.* 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. This is late recognized in revenue when the credits are exchanged for promised awards. ASPE does not specifically address the issue of accounting for loyalty programs; however, it does reflect he general principle that the revenue recognition criteria should be applied “to the separately identifiable components of a single transaction in order to reflect the substance of the transaction.

41. If the costs associated with premiums and rebates are really marketing expenses, the expense approach would be a reasonable way to account for them. On the other hand, IFRS 15 (and previously IAS 18.13 and IFRIC 13) suggest that it may be more appropriate to use the revenue approach, and allocate some of the consideration received from the sales transaction to unearned revenue for the performance obligation associated with the premium or rebate.

### *Unearned Revenues*

42. 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.

### *Contingencies and Uncertain Commitments*

43. A contingency is an existing situation involving uncertainty as to possible gain or loss to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm the acquisition of an asset or the reduction of a liability.

Contingent gains and contingent assets are not recorded in the accounts and our discussion is limited to uncertainty and the recognition of liabilities. How the uncertainty is dealt with currently in accounting is explained below for both ASPE and IFRS.

Under ASPE, the term contingent liability includes the whole population of existing or possible obligations that depend on the occurrence of one or more future events to confirm either their existence or the amount payable, or both. Some of these contingent liabilities are recognized in the accounts, some require only note disclosure, and others are not referred to at all in the financial statements. Under existing international standards, the term “contingent liability” is used only for those existing or possible obligations that are not recognized.

The approach taken by the current standards to deal with whether a liability should be recognized when there is a contingency is to determine the probability of a future event occurring (or not occurring) that would establish whether the outcome is a loss. How likely it is that a future event will confirm the incurrence of a loss and a liability can range from highly probable to remote or unknown.

Under ASPE, the range used to assess this is **likely**, **unlikely, or not determinable**.

A contingent loss is recognized in income and as a liability only if both of the following conditions are met:

a. It is likely that a future event will confirm that an asset has been impaired or a liability has been incurred at the date of the financial statements;

b. The loss amount can be reasonably estimated.

When the liability recognition criteria are not met because a reasonable estimate of the loss amount cannot be determined, or the likelihood of a confirming future event cannot be determined, or when the entity is exposed to loss above the amount accrued, additional information is disclosed in the notes to the statements.

### 44. Under current IFRS, provisions are required for situations such as lawsuits where it is more likely than not that a present obligation exists. Because it is more likely than not that the company will lose, these are considered liabilities (not “contingent liabilities) under IFRS. Provisions are not required for contingent liabilities under IFRS because there are defined as “possible obligations” whose existence will only be confirmed by uncertain future events that may or may not occur.

### The recognition criterion used to determine if a provision should be recognized is based on whether it is “probable” that there will be an outflow of resources. Probably is interpreted to mean “more likely than not.” This is a somewhat lower hurdle than the “likely” required under ASPE. If the amount cannot be measured reliably, the item would be considered a contingent liability and no liability is recognized under IFRS.

### If recognized, IAS 37 requires the best estimated and an “expected value” method to be used to measure the liability. This approach assigns weights to the possible outcomes according to their associated probabilities if a range of possible amounts is available. Unless the likelihood of needing future resources to settle a contingent liability is remote, disclosures are required about the nature of these uncertain amounts and, if practicable: 1) an estimate of its financial effect, 2) information about the uncertainties related to the amount or timing of any outflows, and, 3) whether any reimbursements are possible.

As you might expect, using the terms, “likely” or “probable” to determine the accounting for contingencies and provisions involves considerable judgement and subjectivity. So does the requirement that the amounts be “reliably measureable.”

### *Litigation, Claims, and Assessments*

45. 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***

46. 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*

### 47. 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*

48. **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.

Entities should disclose enough supplementary information about their current liabilities so that readers can understand and identify the entity’s current needs for cash.

49. **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.

50. 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.

Under IFRS, companies are required to disclose a brief description for each class of contingent liability, unless the probability of outflow is remote. They are also encouraged to disclose an estimated of the financial effect of the liability.

51. 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*

52. 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***

53. Text **Illustration 13-14** 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.*

***Looking Ahead***

54 The IASB issued its Conceptual Framework for Financial Reporting which, among other things, provides clearer definitions of assets and liabilities, including more detailed guidance for interpreting the definitions.

The 2010 Exposure Draft of Proposed Amendments to IAS 37 Provisions, Contingent Liabilities and Contingent Assets suggested that the term “contingent liabilities” be eliminated. Under the proposed changes to IFRS, liabilities would arise only from unconditional (or non-contingent) obligations. Uncertainty about the amounts that might be payable would be taken into account in the measurement of the liability, not its existence. However, the July 2015 Staff Paper has made it clear that the current research project is looking at all the issues afresh.

## LECTURE OUTLINE

This chapter can be covered in two or three class sessions. Students should be familiar with trade and payroll liabilities. Short-term obligations expected to be refinanced, accounting for contingencies, and transitioning international financial standards are the conceptually challenging areas for many students.

### *Section 1: Current Liabilities*

A. The Concept of Liabilities

1. The question of **what is a liability** is not a simple issue to resolve. This can be seen if the example of preferred shares is analyzed.

2. IFRS and ASPE identify three essential characteristics for liabilities. However, the key difference is that 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.

B. Current Liabilities

1. Current liabilities can be either financial or non-financial. Financial liabilities are contractual obligations to deliver cash or other financial assets to another entity, or to exchange financial instruments with another entity, under conditions that are potentially unfavourable.

2. Financial liabilities are initially measured and recorded at their fair value and then subsequently at their amortized cost using the effective interest method. Non-financial liabilities under ASPE are generally measured depending on their nature such as the fair value of the goods or services to be given up 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 balance sheet date to settle the present obligation

Financial liabilities do not include obligations resulting from legislation. For example, the income tax payable on corporate income would be a non-financial liability.

3. A liability is classified as current if it meets one of 4 conditions:

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 date of the statement of financial position.

C. Common Current Liabilities:

1. Bank Indebtedness and Credit Facilities: a line-of-credit or revolving debt arrangement. The company draws on the fund as soon as needed when the previous amount is repaid.

2. Accounts Payable: **Trade accounts payable** should be recorded when the goods are received, or the legal title passes to the purchaser.

3. Notes Payable:

a. Trade notes

b. Short-term loan notes**: Interest bearing** notes are presented at their face value, **zero-interest bearing** notes are presented at amortized cost**.**

c. Current maturity of long term debt. That portion of long-term indebtedness that matures within the next fiscal year is reported as a current liability if it is to be paid out of current assets, and if it is not going to be refinanced by a new debt issue or by conversion into shares.

4. Callable Debt and Short-term Obligations Expected to Be Refinanced.

a. **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.

b. 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.

c. Under ASPE, the liability is reclassified as current unless:

* + - 1. the creditor waives the covenant (agreement) requirements, **or**
      2. the violation has been cured within the grace period that is usually given in these agreements, **and**
      3. it is likely that the company will not violate the covenant requirements with a year from the statement of financial position date.

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

### 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.

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### 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.

5. Dividends Payable: At the date of declaration of a **cash dividend** payable the corporation assumes a liability. **Preferred dividends in arrears** are not a legal obligation until a distribution is formally authorized. **Stock dividends** payable are part of shareholders' equity (not a liability).

6. Other liabilities include **returnable deposits and customer advances** and **rents and royalties payable.**

7. Collections for Third Parties:

a. Sales taxes

b. Income tax and other payroll deductions, such as Canada Pension Plan premium, employment insurance, and union dues.

8. Accrued Expenses or Liabilities:

a. Accrued payroll taxes: These would include the employer's share of CPP and employment insurance premiums.

b. Accrued property taxes: The accounting questions involved here are **when the property owner should record the liability**, and **to which periods the cost should be charged.**

9. Compensated Absences: These are absences such as vacations, illnesses, or holidays for which employees are normally paid**. When benefits vest, accrual of the estimated liability is recommended. Accumulating rights** are those rights that can be carried forward to future periods if not used in the period in which earned. **Non-accumulating rights** are those to which employees are entitled if a specific event occurs, such as parental leave or short-term disability.

10. Conditional Payments: These are liabilities that depend on annual income and therefore cannot be known for certain until the end of the period.

a. Profit-sharing plans

b. Bonus agreements

*Non-Financial Liabilities*

D. Decommissioning and Restoration Obligations

1. Obligating Events: Examples include decommissioning nuclear facilities, dismantling, restoring, and reclamation of oil and gas properties, closure and post-closure cost of landfills, and others.

2. Measurement: Under the *CPA Canada 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.

3. 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. 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) or an interest expense (IFRS). Subsequent changes in the ARO due to production are added to the asset’s capital cost under ASPE and inventoried under IFRS.

4. Reporting and Disclosure Requirements: As most of the AROs are long-term in nature, they should be shown outside current liabilities, providing details of the AROs and associated long-lived assets.

E: Unearned Revenues: Non-financial liabilities that are measured at the fair value of the goods or services to be given up in the future.

F. Product Guarantees and Customer Programs

### Businesses often offer continuing care or other customer programs that require them to provide goods and services after they have delivered the initial product or service. Historically an expense approach has been used to account for the outstanding liability, and this type of approach is still used for assurance-type warranties. More recently standards have moved to a revenue approach for warranties that are not included in the sales price of the product (that is, for service-type warranties).

An overview of the two approaches**:**

**Assurance-Type warranty**

Under IFRS 15, when the warranty is part of the sales price, the outstanding liability is measured at the cost of the economic resources needed to meet the obligation. This assurance-type warranty (expense-based approach) assumes that along with the liability that is required to be recognized at the reporting date, the associated expense needs to be measured and matched with the revenues of the period. In fact, the need to match expenses has driven this approach over the years. As the actual costs are incurred in subsequent periods, the liability is reduced. This type of approach has historically been used under ASPE.

**Service-Type Warranty**

Under IFRS 15, when the warranty is sold as an additional service beyond the assurance-type warranty, the outstanding liability is measured at the value of the obligation. It is an output price rather than an input price or cost measure. This is the situation when assets are received in advance for a variety of performance obligations to be delivered in the future. Under a service-type warranty (revenue-based approach), the proceeds received for any goods or services yet to be delivered or performed are unearned at the point of sale. Until the revenue is earned, the obligation-the liability- is reported at its sales or fair value. The liability is then reduced as the revenue is earned. Revenue recognition concerns are at the base of this approach. This parallels the contract-based approach to revenue recognition explained in Chapter 6 where the liability represents a performance obligation for insurance type warranties that are sold separately. Revenue is recognized when the service is provided and the performance obligation is satisfied. Under ASPE, this approach has been used increasingly with bundled sales to bifurcate them (or separate them).

There are two major differences between these approaches:

1. Under the expense approach for assurance-type warranties, the liability is measured at the estimated cost of meeting the obligation. Under the revenue approach for service-type warranties, the liability recognized is measured at the value of the service to be provided, not at its cost.

2. Under the expense approach, and assuming the estimate of the cost of the obligation to be met in the future is close to the actual future cost, there is no effect on future income. Under the revenue approach, future income is affected. Some amount of unearned revenue is recognized as a liability, and this is recognized as revenue in future periods when it is earned or the performance obligation is met. Any expenses associated with that revenue are also recognized in the future. Therefore, future income amounts are affected by the profit or loss earned on the delivery of the goods or services provided in subsequent periods.

### *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. Warranties and product guarantees are stand-ready obligations at the reporting date that result in future costs that are often significant.

IFRS 15 is clear about when the expense approach should be used (for assurance-type warranties) and when the revenue approach should be used (service-type warranties). Similarly, under ASPE the principle is that revenue that covers a variety of deliverables (bundled sales) should be unbundled and the revenue allocated to the various goods or services that are required to be performed. This method has been used increasingly over the past few years, while the expense approach tends to be used when the warranty is not a separate choice for the purchaser, but is included as part of the sales price.

### *Premiums, Coupons, Rebates, and Loyalty Programs*

1. Many companies offer premiums or other benefits to customers in return for box tops, coupons, labels, wrappers, or other evidence of having purchased a particular product. The premiums may be such items as silverware, dishes, small appliances, toys, or cash values against future purchases.

Printed coupons that can be redeemed for a cash discount on items purchased are extremely popular marketing tools, as is the cash rebate, which the buyer can obtain by returning the store receipt, a rebate coupon, and Universal Product Code (UPC label or bar code) to the manufacturer.

Contests have also been used to get consumers’ attention and their sales dollars.

With the life of many contests running a few months and the average coupon being valid for an average of approximately six months, many companies have the practical problem of accounting for these marketing costs, because they often affect more than one fiscal period. Historically, such programs have been accounted for under the expense approach. The accounting issue is that while these promotions increase current sales revenue, the associated costs are often incurred in future periods. The matching concept requires companies to deduct the total estimated costs against the current period’s revenue and the cost is charged to an expense account such as Premium or Promotion Expense. In addition, the obligations existing at the date of the statement of financial position must also be recognized and reported in a liability account such as Estimated Liability for Premiums or Estimated Liability for Coupons Outstanding.

2. Customer loyalty programs where customer loyalty credits are awarded are considered revenue arrangements with multiple deliverables. IFRS initially addressed this via IFRIC Interpretation 13 *Customer Loyalty Programmes, which has been superseded by IFRS 15.* 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. This is late recognized in revenue when the credits are exchanged for promised awards. ASPE does not specifically address the issue of accounting for loyalty programs; however, it does reflect he general principle that the revenue recognition criteria should be applied “to the separately identifiable components of a single transaction in order to reflect the substance of the transaction.

If the costs associated with premiums and rebates are really marketing expenses, the expense approach would be a reasonable way to account for them. On the other hand, IFRS 15 (and previously IAS 18.13 and IFRIC 13) suggest that it may be more appropriate to use the revenue approach, and allocate some of the consideration received from the sales transaction to unearned revenue for the performance obligation associated with the premium or rebate.

G. Contingencies and Uncertain Commitments

1. A contingency is an existing situation involving uncertainty as to possible gain or loss to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm the acquisition of an asset or the reduction of a liability.

Contingent gains and contingent assets are not recorded in the accounts and our discussion is limited to uncertainty and the recognition of liabilities. How the uncertainty is dealt with currently in accounting is explained below for both ASPE and IFRS.

Under ASPE, the term contingent liability includes the whole population of existing or possible obligations that depend on the occurrence of one or more future events to confirm either their existence or the amount payable, or both. Some of these contingent liabilities are recognized in the accounts, some require only note disclosure, and others are not referred to at all in the financial statements. Under existing international standards, the term “contingent liability” is used only for those existing or possible obligations that are not recognized.

The approach taken by the current standards to deal with whether a liability should be recognized when there is a contingency is to determine the probability of a future event occurring (or not occurring) that would establish whether the outcome is a loss. How likely it is that a future event will confirm the incurrence of a loss and a liability can range from highly probable to remote or unknown.

Under ASPE, the range used to asses this is **likely**, **unlikely, or not determinable**.

A contingent loss is recognized in income and as a liability only if both of the following conditions are met:

a. It is likely that a future event will confirm that an asset has been impaired or a liability has been incurred at the date of the financial statements;

b. The loss amount can be reasonably estimated.

When the liability recognition criteria are not met because a reasonable estimate of the loss amount cannot be determined, or the likelihood of a confirming future event cannot be determined, or when the entity is exposed to loss above the amount accrued, additional information is disclosed in the notes to the statements.

### 2. Under current IFRS, provisions are required for situations such as lawsuits where it is more likely than not that a present obligation exists. Because it is more likely than not that the company will lose, these are considered liabilities (not “contingent liabilities) under IFRS. Provisions are not required for contingent liabilities under IFRS because there are defined as “possible obligations” whose existence will only be confirmed by uncertain future events that may or may not occur.

### The recognition criterion used to determine if a provision should be recognized is based on whether it is “probable” that there will be an outflow of resources. Probably is interpreted to mean “more likely than not.” This is a somewhat lower hurdle than the “likely” required under ASPE. If the amount cannot be measured reliably, the item would be considered a contingent liability and no liability is recognized under IFRS.

### If recognized, IAS 37 requires the best estimated and an “expected value” method to be used to measure the liability. This approach assigns weights to the possible outcomes according to their associated probabilities if a range of possible amounts is available. Unless the likelihood of needing future resources to settle a contingent liability is remote, disclosures are required about the nature of these uncertain amounts and, if practicable: 1) an estimate of its financial effect, 2) information about the uncertainties related to the amount or timing of any outflows, and, 3) whether any reimbursements are possible.

As you might expect, using the terms, “likely” or “probable” to determine the accounting for contingencies and provisions involves considerable judgement and subjectivity. So does the requirement that the amounts be “reliably measureable.”

**TEACHING TIP**

The current accounting treatment of loss contingencies can be summarized with the aid of Illustration 13-1.

3. Under IFRS, treatment is similar however the contingent liability term was being considered for elimination under the 2010 ED for IAS 37.

**TEACHING TIP**

Under the *Amendment to IAS 37 Provisions, Contingent Liabilities and Contingent Assets* eliminates the term “contingent liability” based on the fact that a situation either results in a liability or it doesn’t. Liabilities can arise only from unconditional or non-contingent obligations. The only uncertainty that exists is the amount payable, which is taken into consideration on measurement of the liability. Therefore, the focus is on whether the liability actually exists.

4. Litigations, Claims, and Assessments. The following factors should be considered:

a. The period in which the underlying cause for action occurred.

b. The degree of probability of an unfavourable outcome.

c. The ability to make a reasonable estimate of the amount of the loss.

5. Commitments: 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.

6. Financial Guarantees: Private entity standards requires treatment for financial guarantees similar to loss contingencies. requires expanded disclosure by all guarantors about obligations and particularly about the risks that are assumed as a result of issuing guarantees. 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 ant the reporting date and any unamortized premium received as a fee for the guarantee (unearned revenue).

H. Presentation, Disclosures, and Analysis

1. The current liability accounts are generally the first classification in the equity section of the balance sheet.

2. Current liabilities are frequently listed in order of maturity, according to amount, or in order of liquidation preference.

3. Areas that warrant additional disclosure are:

a. Assets pledged as collateral for secured liabilities.

b. Purchase commitments.

c. Short-term obligations expected to be refinanced.

d. Loss contingencies for which a liability has not been recorded.

4. Analysis:

Ratios used to measure the liquidity of a company to determine its ability to meet its current financing and operating obligations include:

a. Current ratio

b. Acid-test ratio

c. Days payables outstanding

I. IFRS and ASPE Comparison

Text **Illustration 13-14** identifies the current differences between IFRS and ASPE in addition an indication of what is expected in a revised standard on *liabilities, a replacement of IAS 37 Provisions, Contingent Liabilities, and Contingent Assets.*

## ILLUSTRATION 13-1

### ACCOUNTING TREATMENT OF LOSS CONTINGENCIES

**Not May be**

**Loss Related to: Accrued Accrued\***

1. Risk of damage of enterprise

property by fire, explosion,

or other hazards X

2. General or unspecified business risks X

3. Risk of damage from catastrophes

assumed by property and casualty

insurance companies including

re-insurance companies X

4. Threat of expropriation of assets X

5. Pending or threatened litigation X

6. Actual or possible claims and

assessments X

7. Guarantees of indebtedness of others X

8. Agreements to repurchase receivables

(or the related property) that have

been sold X

\* Will be accrued when all recognition criteria are met regarding likelihood and measurability.

\*\* See chapter section on Financial Guarantees.

Source: Kieso, Weygandt, *Intermediate Accounting*, Eleventh Edition.

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