CHAPTER 11
Current Liabilities and Contingencies

CPA COMPETENCIES ADDRESSED IN THIS CHAPTER

1.1.2 Evaluates the appropriateness of the basis of financial reporting (Level B)

1.1.4 Explains implications of current trends and emerging issues in financial reporting

  a. Emerging trends in accounting standards and recent updates

1.2.1 Develops or evaluates appropriate accounting policies and procedures (Level B)

1.2.2 Evaluates treatment for routine transactions (Level A)

  g. Provisions, contingencies, and current liabilities

  k. Financial instruments

  p. Foreign currency transactions

1.3.1 Prepares financial statements (Level A)

1.3.2 Prepares routine financial statement note disclosure (Level B)

1.4.1 Analyzes complex financial statement note disclosure (Level C)

LEARNING OBJECTIVES

11-1. Describe the nature of liabilities and differentiate between financial and non-financial liabilities.

11-2. Describe the nature of current liabilities and account for common current liabilities including provisions.

11-3. Describe the nature of contingent assets and liabilities and account for these items.

11-4. Describe the nature of commitments and guarantees and apply accrual accounting to them.

OVERALL APPROACH

This chapter serves two roles. The first is an overview of liabilities, and the second is detailed coverage of current liabilities, contingencies, and commitments. Chapter 12 then deals with non-current financial liabilities, while later chapters cover other more specialized topics that partially involve liabilities (complex financial instruments, accounting for income taxes, pensions, leases).

Copyright © 2020 Pearson Canada Inc.

KEY POINTS

Overview of liabilities: Section B (pp. 519-522) discusses the definition, recognition, classification, and measurement of liabilities. Here, classification precedes measurement because the method of measurement depends on the classification of the particular liability.

The definition of a liability was first introduced in Chapter 2 as part of the conceptual framework. As it will have been a considerable length of time since students covered Chapter 2, it is important to review the three essential characteristics of a liability (a present obligation, arising from past events, and future outflow of economic benefits). It is useful to compare these characteristics with those that define an asset.

The recognition of liabilities, consistent with other financial statement elements, depends on the ability to reliably measure the liability. Reliable measurement does not require certainty—liabilities can be recognized even if they are uncertain in amount or timing.

It is necessary to distinguish financial from non-financial liabilities because the measurement bases may differ. Financial liabilities are a type of financial instrument. IFRS requires that some financial liabilities be measured at their fair value rather than amortized cost.

As previously discussed in Chapter 3, the balance sheet (statement of financial position) usually uses the current / non-current presentation. Presentation by liquidity is rare (e.g., for financial institutions) and outside of what students would be expected to know and apply in intermediate accounting. Those liabilities maturing within one year of the balance sheet date are current; any fair value through profit or loss (FVPL) financial liabilities would also be presented as current.

The measurement of liabilities depends on their classification.

- Financial liabilities at FVPL – measure initially and subsequently at fair value. As noted above, these liabilities are outside of what students are expected to know, so they are not covered in further detail.
- Other financial liabilities – measure initially at fair value minus transaction costs; subsequent measurement at amortized cost using the effective interest rate method. Covered in more detail in Chapter 12 and also discussed in Chapter 7.
- Non-financial liabilities – measure according to their nature. When the difference between the present value of future cash flows and the nominal value is material, use present value to measure the liability. Additional coverage follows in the next section.

Current liabilities: Section C covers a range of current liabilities. The eight examples are not comprehensive but do capture the most commonly encountered items.

Copyright © 2020 Pearson Canada Inc.

1. Trade payables should be familiar to students. Two issues require further discussion:

    a. The concept of "cut off." Cut off refers to ensuring that all obligations entered into during a reporting period are properly recognized in the correct period. Cut off is an important concept and is pervasive across all elements of the financial statements. Incorrect cut off can cause errors or omissions in reporting. Some examples are:

        - Sales invoices recognized at year end but goods do not ship until the beginning of the next fiscal period. This will overstate sales and accounts receivable.

        - Failure to accrue expenses in the current period that have been incurred but not yet paid. This will understate expenses and accounts payable.

        - Failure to record purchases for goods received. This will understate accounts payable and inventory.

    b. The difference between the gross and net methods of recording cash discounts. Although the net method is more conceptually sound, the gross method is more commonly used. Businesses can justify using the gross method based on the cost- benefit and materiality constraints. Some students may recall that the mirror image of this issue was covered in Chapter 5 on accounts receivable. Also similar to accounts receivable is the fact that trade payables are not usually discounted for the time value of money due to the relatively high volume of transactions and the low amount of interest that would be imputed.

2. Common non-trade payables are other short term obligations that are indirectly related to the normal business activities of an organization. These include, but are not limited to: sales taxes payable, income taxes payable, dividends payable, and royalty fees payable. Some specific issues to note about these payables follow.

    a. Sales tax liabilities are classified as non-financial liabilities because they are legislated and not contractual. There is a risk that discussion here can become complicated because of the diversity of sales tax regimes in different provinces, and the technical details of the tax rules. It is, therefore, important to focus on the *accounting* for these taxes, not the specific tax rules. The important point to note is that an enterprise merely acts as an agent of the government, so that any taxes charged on sales made to customers are the property of the government and payable to it. On the purchases side, GST/HST paid on inputs are refundable to the enterprise and are therefore recorded as GST/HST recoverable. In contrast, PST paid is generally not recoverable. (PST is not payable on goods purchased for resale, while PST on goods not for

Copyright © 2020 Pearson Canada Inc.

resale becomes part of the cost of the items.) Page 525 discusses some of the complexities that can arise when accounting for sales taxes.

b. Income taxes payable are classified as non-financial liabilities also. Income taxes will be covered in more detail in Chapter 18.

c. Dividends payable occur when *cash* dividends are *declared* but not yet paid. The payable will normally be classified as current and the obligation only arises when dividends are declared; no amounts are accrued for cumulative preferred dividends in arrears. Stock dividends do not give rise to a liability and can be revoked by the board of directors before issuance.

d. Royalty fees arise from contractual obligations in a franchise agreement; therefore, unpaid royalty fees owing represent a current liability.

3. A note payable is distinct from trade payable by whether it is supported by a written promise to pay (i.e., a promissory note). Because of the lower frequency of these transactions and related record-keeping costs, and the larger amount of interest that is typically expected, we generally record notes payable at discounted present value. However, enterprises often ignore immaterial amounts of interest on notes with very short durations (90 days or less). Interest-bearing notes are initially recognized at the fair value of the consideration received and non-interest-bearing notes are measured at discounted present value. This section keeps the discussion of discounting at a simple level by assuming that the stated rate on the note is the same as the market rate. Differences in rates are left to the coverage of long-term debt in Chapter 12.

4. Credit (loan) facilities (e.g., line of credit) are commonly used to manage seasonal fluctuations in cash flows and balances. Recording the amount owed is straight-forward; the issue here relates to the disclosures required to detail the credit facilities available to the enterprise.

5. Warranties can be either a part of a product, or sold separately. The latter was covered in Chapter 4 on revenue recognition, so the focus here is on the former (manufacturers' warranties). Warranties are a type of contingency, which is discussed more thoroughly later in the chapter, because the outflow of resources depends on the outcome of future events (i.e., the product malfunctioning during the warranty period). Because the likelihood of loss is probable, and the amount can be reasonably estimated, IFRS treats warranty costs as a type of provision. The amount of the provision requires the use of expected value techniques (e.g., weighted average). Where the warranty obligations are deemed immaterial, the costs can be expensed as incurred.

6. Deferred revenue is a liability that was previously covered in Chapter 4 on revenue recognition. If the deferred revenue relates to a simple promise to deliver goods or

Copyright © 2020 Pearson Canada Inc.

services at a later date, then the accounting is fairly straight-forward. However, there are more complex examples of deferred revenue, such as frequent flyer miles, discussed next.

7. Customer incentives. Many companies offer various incentives to customers to purchase their products and services. These incentives may be in the form of customer loyalty programs, premiums, coupons, and rebates.

    a. Customer loyalty programs give rise to deferred revenue. These loyalty programs involve the initial delivery of the primary product, plus a promise of future goods or services. Depending on who provides the future goods or services, the accounting differs. If a third party supplier is involved, then the reporting entity simply records an expense for the amount it needs to pay the third party for the loyalty points. If the reporting entity itself supplies the rewards, then it must treat the transaction as having multiple deliverables: those for the initial sale and those for the future delivery of rewards.

    b. Premiums are goods and services that can be purchased by customers by exchanging "points" earned from past purchases. Discount vouchers (coupons) entitle a customer to a discount off the retail price. Rebates require a customer to apply for a refund on a retail purchase. Premiums are accounted for similar to customer loyalty programs in that the initial sales represent a multiple deliverable. Measurement of the liability for the premium references the value to the customer, not the cost to the entity. Measurement of coupon and rebate liabilities is similar to the accounting for warranties. Where management's initial estimates prove incorrect, changes to the estimates are treated prospectively.

8. Other current liabilities. There are many other types of current liabilities, including certain obligations to employees. Some liabilities that warrant special consideration given their unique characteristics are:

    a. Obligations denominated in foreign currencies should be translated into the functional currency (usually Canadian dollars) at the transaction date, and then revalued at the end of a period using the exchange rate at that time. Any resulting gain or loss flows through income.

    b. Maturing debt to be refinanced and non-current debt in default create some interesting reporting issues. Exhibit 11-16 (p. 542) summarizes the treatments. The reporting outcomes depend on whether the enterprise obtains the renewal or grace period prior to (i) the year-end or (ii) the financial statement approval date.

Copyright © 2020 Pearson Canada Inc.

Contingencies: Section D's coverage of contingencies takes a more fundamental approach to the topic than a simple interpretation of the standards. The reason is that the standards in IFRS relating to contingencies is convoluted and uses terminology that differs from plain English and from that used in ASPE. IFRS defines contingent assets and liabilities, while ASPE defines contingent gains and losses. Confusingly, IFRS defines a contingent asset or liability based on the accounting outcome rather than its nature; contingent assets and liabilities are essentially those that are *not recognized* as assets or liabilities, *but which require disclosure* as a possible asset or liability.

To avoid the conflicting technical wording in the two sets of standards, the chapter uses the plain-English terms "contingencies," "contingent outflows," and "contingent inflows." For each of contingent outflows and contingent inflows, the two criteria of likelihood (remote, possible, probable) and measurability can then be applied. The result for outflows is the 2×3 matrix in Exhibit 11-18 (p. 543). The result for inflows is simpler: recognize if virtually certain and measurable; disclose as contingent asset if probable.

Another significant difference between IFRS and ASPE are the terms used for the upper category of likelihood: IFRS uses "probable" meaning >50% while ASPE uses "likely," which is usually interpreted to mean >70%.

Exhibit 11-19 (p. 545) provides accounting treatments for contingent outflows. It is important to note that uncertainty exists when estimating contingent liabilities and many other types of liabilities.

Commitments and guarantees: A commitment requires an enterprise to do something in the future. We can think of a guarantee as a contingent commitment, since a future adverse event must occur before action is required from the enterprise providing the guarantee. Commitments and guarantees generally require disclosure. A commitment is not recognized as a liability because it is a mutually unexecuted contract (or "executory contract"), unless the commitment involves an onerous contract. An onerous contract is one in which the unavoidable costs of fulfilling the contract exceed the benefits expected to be received (i.e., it will result in negative net outflows from the enterprise). An enterprise with an onerous contract must recognize the expected loss.

USE OF END-OF-CHAPTER PROBLEMS AND CASES

In addition to lectures, discussion of some of the end-of-chapter problems and cases will help students apply the concepts. The following table identifies the suggested problems and cases that can be used in class, and problems and cases that can be used for homework assignments. (Depending on the time allocation between lectures and examples, it may not be feasible to cover all of the suggested items.)

Copyright © 2020 Pearson Canada Inc.

Table 11-1:
Summary of learning objectives, chapter content, and suggested problems and cases

L.O. number	Learning objective	Pages	Suggestions for in-class discussion	Suggestions for assignments
11-1.	Describe the nature of liabilities and differentiate between financial and non-financial liabilities.	555-556	P11-2 P11-3	P11-5
11-2.	Describe the nature of current liabilities and account for common current liabilities including provisions.	556-557 560-561 568	P11-6 P11-18	P11-8 P11-15 P11-38
11-3.	Describe the nature of contingent assets and liabilities and account for these items.	568-569	P11-38	P11-41
11-4.	Describe the nature of commitments and guarantees and apply accrual accounting to them.	570-572	P11-48	P11-50
--	Integrative	573-578	Case 1	Case 2

Case 1 involves a (simulated) company that will potentially breach bank covenants and as a result it would need to repay a significant bank loan. The student, playing the role of the auditor, must apply professional judgment to conclude how various transactions and accounts should be reflected in the financial statements. The accounting potentially affects whether the company is able to meet the bank covenants.

Case 2 involves another simulated company that has to procure significant refinancing to continue operations. The financial statements had not been previously audited, but audited statements are a condition of the new financing. The new financing agreement also contains a number of requirements based on financial statement balances and ratios. Students must apply professional judgment to determine the appropriate treatment of various accounting issues and the implications for the financial statement balances and ratios.

Copyright © 2020 Pearson Canada Inc.