INTERMEDIATE ACCOUNTING

KIN LO GEORGE FISHER THIRD EDITION VOLUME TWO

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THIRD EDITION VOLUME TWO

KIN LO
University of British Columbia

GEORGE FISHER
Douglas College

With contributions by

TREVOR HAGYARD
Concordia University

ZVI SINGER
McGill University

PEARSON
Toronto

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Kin:

In memory of my mother, who did not have the benefit of schooling, but gave me the freedom to question, unconditional support of my pursuits, and the humility to know that there is always more to learn.

George:

My passion for teaching has been richly rewarded by many opportunities including the privilege of co-authoring this text. I dedicate this book to my wife, Gail, and my family, friends, colleagues, and students who have encouraged me along the way.

About the Authors

Kin Lo, PhD, FCPA, FCA is the Senior Associate Dean—Students at the Sauder School of Business, University of British Columbia. He holds the CA Professorship in Accounting established by the Institute of Chartered Accountants of British Columbia (ICABC). After receiving a Bachelor of Commerce from the University of Calgary, he articled at PricewaterhouseCoopers and subsequently earned his doctorate from the Kellogg School of Management at Northwestern University in Chicago in 1999. His research has been published in the most important accounting journals, including *Journal of Accounting Research* and *Journal of Accounting and Economics*, and he has served as an Associate Editor at the latter journal from 2003 to 2011.

Since joining UBC in 1999, Professor Lo has taught extensively in intermediate-level financial accounting for undergraduates, as well as master and doctoral-level courses. He has coached numerous winning teams in regional, national, and global case competitions. His outstanding teaching has been recognized by the Killam Teaching Prize. Kin has also been a visiting professor at MIT Sloan School of Management and the University of California at Irvine's Merage School of Business.

Aside from research and teaching, Kin is also active in the professional accounting community, serving on provincial and national committees and contributing as a columnist to the ICABC's magazine *Beyond Numbers*. From 2008 to 2011, Professor Lo was a member of the Board of Evaluators for the Chartered Accountants' national Uniform Final Evaluation (UFE). He is a member of the Academic Advisory Council for the Accounting Standards Board of Canada. In recognition of his contributions to accounting education, he was awarded Fellowship by the ICABC in 2013. Kin is also an avid sailor.

George Fisher, MBA, CPA,CGA is the Chair of Accounting at Douglas College where he teaches financial accounting in the College's Bachelor of Business Administration and Post-Degree Diploma programs.

For the past three years, Mr. Fisher has been actively involved in the development of curriculum for the Chartered Professional Accountants. His publications for CPA Canada include *Module 5.1, Intermediate Financial Reporting 1*; *Module 5.2, Intermediate Financial Reporting 2*;and *Module 5.3, Advanced Financial Reporting*. Mr. Fisher also co-led the development of the finance elective for the CPA Professional Education Program.

Mr. Fisher waspreviously associated with the Certified General Accountants for more than 15 years in several roles. His publications for CGA Canada include *Model Financial Statements,* and the domestic and international versions of *Corporate Finance Fundamentals* (*FN1*), *Financial Accounting: Assets* (*FA2*), and *Financial Accounting: Consolidations and Advanced Issues* (*FA4*).

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Preface

"There is too much material to learn!" is a complaint commonly heard among both students and instructors of intermediate-level financial accounting. The current environment in Canada involving multiple accounting standards certainly adds to the problem. However, this sentiment was prevalent even before the splintering of Canadian generally accepted accounting principles (GAAP) in 2011. So what is the source of the problem, and how do we best resolve it?

Regardless of one's perspective—as an instructor of intermediate accounting, as a student, or as a researcher reading and writing papers—often *the problem of too much content is an illusion*. Instead, the issue is really one of *flow*, not just of words, but *of ideas*. Why does a class, research paper, or presentation appear to cover too much, and why is it difficult to understand? Most often, it is because the ideas being presented did not flow—they were not coherent internally within the class, paper, or presentation, or not well connected with the recipients' prior knowledge and experiences.

Connecting new ideas to a person's existing knowledge and efficiently structuring those new ideas are not just reasonable notions. Modern neuroscience tells us that for ideas to be retained they need to be logically structured to each other and presented in ways that connect with a person's prior knowledge and experiences.

OUR APPROACH

How can we better establish the flow of ideas in intermediate accounting? One way is to apply more accounting theory to help explain the "why" behind accounting standards and practices. Inherently, humans are inquisitive beings who want to know not just how things work, but also why things work a particular way. When students understand "why," they are better able to find connections between different ideas and internalize those ideas with the rest of their accumulated knowledge and experiences.

This approach contrasts with that found in other intermediate accounting textbooks, which present accounting topics in a fragmented way, not only between chapters but within chapters. For example, how is the conceptual framework for financial reporting connected with other ideas outside of accounting? How do the components such as qualitative characteristics relate to the elements of financial statements? Fragmented ideas are difficult to integrate into the brain, which forces students to rely on memorization tricks that work only for the short term. For example, a frequently used memory aid for the conceptual framework is a pyramid; this is a poor pedagogical tool because the concepts within the diagram are not logically connected and the pyramid shape itself has no basis in theory. In contrast, we anchor the conceptual framework on the fundamental notions of economic demand and supply.

Also different from other textbooks, we do not aim to be encyclopedic—who wants to read an encyclopedia? This textbook is designed as a learning tool for students at the intermediate level, rather than as a comprehensive reference source they might use many years in the future. Being comprehensive burdens students with details that are not meaningful to them. At the rate at which standards are changing, books become outdated rapidly, and students should learn to refer to official sources of accounting standards such as the *CPA Canada Handbook*.

ARE INTERMEDIATE ACCOUNTING STUDENTS READY FOR ACCOUNTING THEORY?

Most programs that offer an accounting theory course do so in their final year, with good reason—concepts in accounting theory are difficult. Thorough exploration of these concepts requires a solid grounding in accounting standards and practices and higher-level thinking skills. However, not exposing students to these concepts earlier is a mistake.

Other management (and non-management) disciplines are able to integrate theory with technical applications. For example, when finance students study investments and diversification, the capital asset pricing model is an integral component. Finance students also learn about firms' capital structure choices in the context of Modigliani and Miller's propositions, the pecking order theory, and so on. Students in operations management learn linear programming as an application of optimization theory. Relegating theory to the end of a program is an exception rather than the rule.

Accounting theory is too important to remain untouched until the end of an accounting program. This text exposes students to the fundamentals of accounting theory in the first chapter, which lays the foundation for a number of *threshold concepts* (see Meyer and Land, 2003[1]).

THRESHOLD CONCEPTS

While by no means perfect, this textbook aims to better establish the flow of ideas throughout the book by covering several threshold concepts in the first three chapters. Threshold concepts, in this case, are the portals that connect accounting standards and practices with students' prior knowledge and experiences. As Meyer and Land suggest, these threshold concepts will help to *transform* how students think about accounting, help students to *integrate* ideas within and between chapters, and *irreversibly improve* their understanding of accounting. Introducing these concepts is not without cost, because threshold concepts will often be troublesome due to their difficulty and the potential conflict between students' existing knowledge and these new concepts.

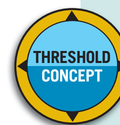
The inside front cover identifies the threshold concepts and the layout of the chapters in both volumes of this text. Crucially, the first chapter in Volume 1 begins with the threshold concepts of *uncertainty* and *information asymmetry* . The need to make decisions under uncertainty and the presence of information asymmetries results in *economic consequences of accounting choice.* Those consequences differ depending on whether the accounting information interacts with *efficient securities markets.* These concepts open up the notion of *supply and demand for accounting information*, which forms the basis of the *conceptual frameworks* for financial reporting (Chapter 2). Decision making under uncertainty leads to the issues surrounding the *timing of recognition* under accrual accounting (Chapter 3), which in turn lead to the concept of *articulation* between financial statements. Accounting choices having economic consequences leads to considerations of the *quality of earnings* and the potential for earnings management (Chapter 3).

These concepts then resurface at different points in the remaining 17 chapters. For example, the concept of information asymmetry is fundamental to understanding the reasons that companies issue complex financial instruments (Chapter 14). Another example is the important role of the moral hazard form of information asymmetry

[1] Meyer, J.H.F., and R. Land. 2003. "Threshold Concepts and Troublesome Knowledge 1: Linkages to Ways of Thinking and Practicing". In *Improving Student Learning: Ten Years On*, C. Rust (Ed.), Oxford, UK: Oxford Centre for Staff and Learning Development.

in explaining why accounting standards do not permit the recognition of gains and losses from equity transactions through net income. A third example is the influence of uncertainty and executives' risk aversion on the accounting standards for pension plans, which allow the gains and losses to flow through other comprehensive income rather than net income. A fourth example is the application of information asymmetry to the accounting for leases (Chapter 18).

As an aid for students, we have put threshold concepts icons in the margin to identify when these concepts appear in the various chapters. To further clarify these icons, in the third edition we have added the name of the specific concept next to the icon to ensure students understand which concepts are being referenced.



ACCOUNTING STANDARDS AND PRACTICES

Along with the unique approach of introducing and integrating theory through the use of threshold concepts, this text also provides thorough coverage of accounting standards and practices typically expected of an intermediate accounting course. This edition reflects recently issued standards, including IFRS 15 on revenue recognition and IFRS 9 on financial instruments.

Following an overview of the four financial statements in Chapter 3 in Volume 1, Chapter 4 explores revenue and expense recognition to highlight the connection financial reporting has to enterprises' value-creation activities. Chapters 5 to 10 in this book then examine, in detail, issues involving the asset side of the balance sheet.

The second volume begins with coverage of the right-hand side of the balance sheet in Chapters 11 to 13. Coverage in Chapters 14 to 18 then turns to special topics that cut across different parts of the balance sheet and income statement: complex financial instruments, earnings per share, pension costs, income taxes, and leases. Chapter 19 examines the statement of cash flows, which integrates the various topics covered in Chapters 4 through 18. Chapter 20 revisits the topic of accounting changes introduced in Chapter 3.

INTEGRATION OF IFRS

This is the first Canadian text written with International Financial Reporting Standards (IFRS) in mind throughout the development process, rather than as an afterthought. For example, we devote a separate chapter (Chapter 10) to explore issues surrounding asset revaluation and impairment because these issues cut across different asset categories under IFRS. The complete integration of standards in the development process adds to the smooth flow of ideas in and between chapters. Another example is Chapter 10's coverage of agriculture activities, a topic covered by IFRS but not by past Canadian standards.

COVERAGE OF ASPE

While this text puts emphasis on IFRS, we do not neglect Accounting Standards for Private Enterprises (ASPE). Near the end of each chapter is a table that identifies differences between IFRS and ASPE. In contrast to other textbooks, we identify only substantive differences rather than every detail. In addition to the summary table, we carefully choose to discuss certain important differences in the main body of the chapters to create opportunities for understanding the subjective nature of accounting standards and the advantages and disadvantages of different standards. For example, Chapter 8 discusses the different treatments of interest capitalization under IFRS and ASPE. In the end-of-chapter Problems, we have placed icons in the margin to identify questions that apply ASPE instead of IFRS.

A·S·P·E

REFERENCE TO ACCOUNTING STANDARDS

Consistent with the threshold concepts described above, this textbook avoids treating accounting standards as written in stone and with only one interpretation. Ultimately, it is people who make accounting standards and it is important to analyze and evaluate the choices that standard setters make to understand the rationale behind the standards. Where appropriate, the chapters provide specific quotations from authoritative standards so that students begin to develop their ability to interpret the standards themselves rather than rely on the interpretations of a third party.

INTEGRATION OF LEARNING OBJECTIVES

To enhance the flow of material, each chapter fully integrates learning objectives from beginning to end. Each chapter enumerates four to six learning objectives that the chapter covers. The end of each chapter summarizes the main points relating to each of these learning objectives. We have also organized the problems at the end of each chapter to match the order of these learning objectives as much as possible.

INTEGRATION OF CPA COMPETENCIES

To ensure students are building the knowledge and skills required for the CPA designation, the third edition has increased its focus on covering the competencies outlined in the CPA Competency Map and Knowledge Supplement. Each chapter now opens with a list of CPA Competencies, related Knowledge Items, and levels that are covered in that chapter; also, a master list of all the financial reporting Competencies and Knowledge Items is available on the back inside cover. As well, all the problems on MyAccountingLab for *Intermediate Accounting* 3e are mapped to the Competency, Knowledge Item, and level that is being assessed. These features will allow students and faculty interested in the CPA designation to become familiar with the Competency Map and the material covered in the book.

CHAPTER FEATURES

This text contains a number of features that augment the core text. We are mindful that too many "bells and whistles" only serve to distract students, so we have been selective and have included only features that reinforce student learning. The result is an uncluttered page layout in comparison to competing textbooks. We firmly believe that clean design supports clear thinking.

Opening Vignettes

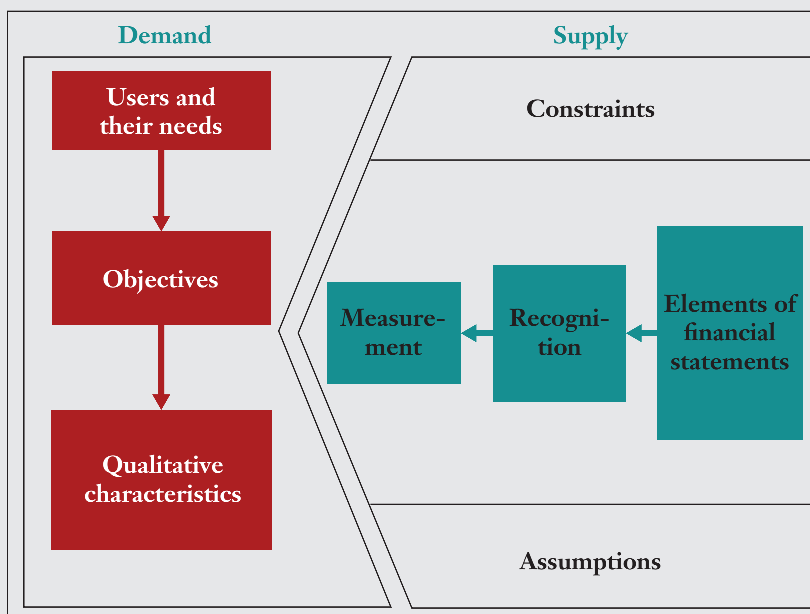
Each chapter opens with a short vignette of a real-world example that students will easily recognize and to which they will relate. These examples range from household names such as Bank of Montreal, Bombardier, and Telus, to car shopping and Christopher Columbus. As mentioned earlier, this connection to existing knowledge and experiences is crucial to learning new concepts. Each vignette serves to motivate interesting accounting questions that are later addressed in the chapter.

Charts and Diagrams

We have chosen to use graphics sparingly but deliberately. These graphics always serve to augment ideas in a logical way rather than to serve as memory "gimmicks" that lack meaning. For instance, it has been popular to use a triangle to organize the Conceptual Framework for financial reporting. We eschew the use of this triangle because that

shape has no logical foundation or connection with the Conceptual Framework. Instead, we develop the Conceptual Framework from fundamental forces of supply and demand, so we provide a diagram that illustrates the interaction of those forces:

Exhibit 2-2 Outline of a conceptual framework for fi nancial reporting



Feature Boxes

When warranted, we provide more in-depth discussions to reinforce the core message in the main body of the chapters. These discussions often take the form of alternative viewpoints or surprising research results that serve to broaden students' perspectives on the issues. Compass icons identify these feature boxes to denote the different perspectives on various issues.

STILL WAITING…

In 1670, an incorporation under the British royal charter created "The Governor and Company of Adventurers of England trading into Hudson's Bay." The charter gave the company exclusive rights to the fur trade in the watershed flowing into Hudson Bay. The company continues to operate today as The Hudson's Bay Company. It was publicly traded until January 2006, when it was purchased by private equity firm NRDC Equity Partners. If investors had to wait until dissolution to find out what happened to their investments, they would have been waiting for almost three and a half centuries—and counting!

Checkpoint Questions

At important transitional points in each chapter, we pose "Checkpoint Questions" to engage students to reflect upon what they have just read, and to review, if necessary, before proceeding to the next portion of the chapter. These questions appear at the end of sections and there are five to ten such questions within each chapter. To encourage students to think about these questions before looking at the answers, we have placed the answers toward the end of each chapter, immediately after the chapter summary.

End-of-Chapter Problems

The end of each chapter contains many questions for students to hone their skills. Each chapter in the third edition features new questions, covering new chapter material and IFRS standards. We choose to use a single label—Problems—for all questions. This choice follows from our focus on learning objectives. We have organized the Problems

in the order of the learning objectives, and within each learning objective according to the Problem's level of difficulty (easy, medium, or difficult). This approach allows students to work on each learning objective progressively, starting with easier questions and then mastering more difficult questions on the same learning objective. This approach is much preferable to having students jump around from "exercises" to "discussion questions" to "assignments," and so on. Problems in the textbook that are coloured red are also available on MyAccountingLab. Students have endless opportunities to practise many of these questions with new data and values every time they use MyAccountingLab.

MyAccountingLab

Make the grade with **MyAccountingLab**: The problems marked in red can be found on **MyAccountingLab**. You can practise them as often as you want, and most feature step-by-step guided instructions to help you fi nd the right answer.

Cases

We have included Mini-Cases that are based on, or mimic, real business scenarios. The distinguishing feature of these cases is their focus on decision making. While they are technically no more challenging than Problems, cases bring in additional real-world subjective considerations that require students to apply professional judgment.

We have also included an appendix that provides case solving tips to students, as well as three comprehensive cases that cover topics across multiple chapters and two capstone cases that cover many of the topics in both volumes of the textbook. These cases simulate those on professional exams that require four to five hours of an entry-level professional accountant.

TECHNOLOGY RESOURCES

MyAccountingLab

MyAccountingLab delivers proven results in helping individual students succeed. It provides engaging experiences that personalize, stimulate, and measure learning for each student. MyAccountingLab is the portal to an array of learning tools for all learning styles—algorithmic practice questions with guided solutions are only the beginning. MyAccountingLab provides a rich suite of learning tools, including:

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- A personalized study plan
- An online, interactive Accounting Cycle Tutorial, reinforcing students' understanding of accounting foundations
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- A Case Solving Primer
- Sample Tests
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- **Instructor's Resource Manual.** The Instructor's Resource Manual features additional resources and recommendations to help you get the most out of this textbook for your course.
- **Computerized Test Bank**. Pearson's computerized test banks allow instructors to filter and select questions to create quizzes, tests or homework. Instructors can revise questions or add their own, and may be able to choose print or online options. These questions are also available in Microsoft Word format.
- **PowerPoint® Presentations.** Approximately 30–40 PowerPoint® slides, organized by learning objective, accompany each chapter of the textbook.
- **Image Library.** The Image Library provides access to many of the images, figures, and tables in the textbook.

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Kin Lo
George Fisher

INTERMEDIATE ACCOUNTING

THIRD EDITION VOLUME TWO

CHAPTER 11
Current Liabilities and Contingencies

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

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

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

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

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

CPA competencies addressed in this chapter:

1.1.2 Evaluates the appropriateness of the basis of financial accounting (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)

Fortis Inc. is the largest investor-owned utility engaged in the distribution of natural gas and electricity in Canada. In British Columbia, the company's operations are known as FortisBC, which includes what was previously Terasen Inc. In 2000, Terasen built a natural gas pipeline through the interior of British Columbia. To facilitate the construction, Terasen purchased millions of dollars in equipment. Terasen carefully structured its affairs to avoid paying the 7% provincial sales tax (PST) on the equipment purchase. Avoidance techniques included reselling the equipment to a trust it created for this purpose and leasing the equipment back.

In 2006, the BC government reassessed Terasen and ordered the company to pay an additional $37.1 million in PST, which through negotiation was reduced to $7.0 million including interest. In 2009, the trial court found in favour of Terasen, setting aside the BC government's reassessment. In 2010, the BC Court of Appeal upheld the trial court's decision.

How do companies such as Terasen determine the amount to report as liabilities at the end of a fiscal year? What is required when the amount originally estimated is subsequently found to be incorrect? What do they do when the amount owed depends on the outcome of a future event?

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A. INTRODUCTION

In simple terms, liabilities are obligations to provide cash, other assets, or services to external parties. However, this perspective suffices for only simple transactions and balances. For anything other than rudimentary transactions and balances, we must look to the framework and specific standards in IFRS (International Financial Reporting Standards). As alluded to in the opening vignette regarding Terasen, substantive challenges can exist in determining the amount that must ultimately be paid, because a number of different factors can affect the value of the indebtedness. These factors include whether:

- the obligation is a financial liability or a non-financial liability;
- the market rate of interest is different from that recorded in the loan documentation;
- the market rate of interest has changed since the liability was incurred;
- there is uncertainty about the amount owed;

- the amount owed depends upon the outcome of a future event; or
- the obligation is payable in a foreign currency.

In this chapter and the next, we will examine how these (and a few other) factors affect the value of the indebtedness reported on the balance sheet.

The amount reported for liabilities is important to creditors, investors, suppliers, and other interested parties. Information on how much the company owes, to whom, and when the amounts are due is useful to stakeholders in their decisions to lend to the firm, to invest in the company, or to extend trade credit.

CHECKPOINT **CP11-1**

List four factors that can affect the value of indebtedness.

B. DEFINITION, CLASSIFICATION, AND MEASUREMENT OF LIABILITIES

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

Financial statements convey information. For any communication to be effective, the receiver must understand the sender's message. Imagine that you are travelling in Italy and ask, in English, for directions from a passerby. If that person speaks English, he or she will comprehend your request and will probably assist you. However, a person who speaks only Italian will not understand you and will not be able to help. This example extends to communicating information of a technical nature, like accounting, even when a language barrier does not exist. For instance, if a physicist summarizes Einstein's theory of relatively as "$E = mc^2$; energy and mass are equivalent and transmutable," you will have little chance of understanding what the scientist is trying to communicate unless you know that E stands for energy, m for mass, and c for the speed of light. To enhance the quality of communication between preparers and users of financial statements, IFRS defines key terms in each of its standards. We will now discuss some of these definitions pertaining to liabilities.

1. Liabilities defined

IAS 37 defines a liability as follows:

liability A present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow of resources.

> ¶10 A ***liability*** is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.[1]

This definition includes three key elements, as elaborated on in Chapter 4, of IFRS *The Conceptual Framework for Financial Reporting,* paragraphs 15–17:

1. it is a present obligation;
2. arising from a past event; and
3. expected to result in an outflow of economic benefits.

This is an "and" situation, as all three criteria must be satisfied. Present obligations are normally legally enforceable but can also be constructive in nature (i.e., obligations that arise from recurring practice). For example, a company that regularly repairs products after the warranty period to maintain good customer relations would report a liability for the amounts that are expected to be expended both in the warranty period and in the period afterward.

The past event criterion is fairly straightforward: present obligations normally arise from past events rather than a decision to do something in the future. For example, if you borrowed money from a bank last week—a past event—you incurred a

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liability and have a present obligation. If, however, last week you simply resolved to borrow money from the bank next week—a decision to do something in the future—you have not yet incurred a liability.

The expectation of an outflow of economic benefits is also relatively uncomplicated. For a liability to exist, you must have an expectation that you are going to give up something in the future to satisfy the creditor's claim. That "something" could be cash, other assets, or services.

CHECKPOINT **CP11-2**

What are the three criteria of liability?

2. Recognition

The definition of a liability set out above does not require that we know the precise amount of the obligation. Just as for assets, recognition on the financial statements requires a liability to be measured reliably (IAS 37 paragraph 14). However, IAS 37 suggests that it would be rare that a reliable estimate cannot be obtained. This presumption differs from the treatment of assets, which may or may not be measured reliably (e.g., research and development).

The fact that there is uncertainty over the amount or timing of payments does not imply that a liability cannot be reliably measured. For example, payments for warranty costs are uncertain in terms of both amount and timing, yet we would still record a liability for the estimated cost of fulfilling warranties. **Provision** is the IFRS terminology used to refer to liabilities that have some uncertainty with respect to the timing or amount of payment. All provisions are liabilities.

provision A liability in which there is some uncertainty as to the timing or amount of payment.

3. Financial and non-financial liabilities

In the introduction, we suggested that whether an obligation is a financial or non-financial liability may impact how the debt is valued. A **financial liability** is a contractual obligation to deliver cash or other financial assets to another party. For example, a loan from the bank is a financial liability of the company that borrowed the money. Non-financial liabilities are obligations that meet the criteria for a liability, but are not financial liabilities. Non-financial obligations are typically settled through the delivery of goods or provision of services. For instance, magazines routinely sell subscriptions for one or more years. The publisher's obligation to the subscribers is to provide the magazine for the agreed-upon period. This is a non-financial liability as it will be settled by delivering the periodical, rather than paying cash or providing a financial asset. Warranties are another example of non-financial liabilities. Lastly, liabilities established by legislation such as income taxes payable and provincial sales tax payable are also non-financial liabilities as they are not contractual in nature. For example, if Terasen had lost the court challenge, its resultant PST payable would have been non-financial in nature.

financial liability A contractual obligation to deliver cash or other financial assets to another party.

From an accounting perspective, it is important to distinguish between financial and non-financial liabilities as IFRS requires that some financial liabilities be measured at their fair value rather than amortized cost. Amortized cost is discussed in Chapter 12.

4. Current versus non-current liabilities

Current liabilities, the primary focus of this chapter, are obligations that are expected to be settled within one year of the balance sheet date or the business' normal operating cycle, whichever is longer. As most businesses' operating cycles are one year or less, we will simply refer to current liabilities as those due in the following year. In addition to these criteria, IAS 1, paragraph 69(d) also requires that an entity shall classify a liability as current if it does not have an unconditional right to defer settlement

current liabilities Obligations that are expected to be settled within one year of the balance sheet date or the business' normal operating cycle, whichever is longer. Also includes liabilities at fair value through profit or loss, and liabilities that the entity does not have an unconditional right to defer settlement of for at least twelve months after the reporting date.

of the liability for at least twelve months after the reporting period. IAS 1, paragraph 60, normally requires that current liabilities be presented separately from non-current liabilities in the balance sheet.[2]

In addition to the length of time until maturity, certain financial liabilities classified as "at fair value through profit or loss (FVPL)" would also be reported as current liabilities.[3] In practice, relatively few companies elect to report financial liabilities as FVPL.

5. Measurement

The process of measuring a liability, both initially and subsequently, is determined to some degree by the nature of the obligation. Broadly speaking, we have three categories of indebtedness:

fair value The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

a. *Financial liabilities at fair value through profit or loss (FVPL)* should be initially and subsequently measured at fair value. (Recall that **fair value** is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.)
b. *Other financial liabilities* (i.e., not FVPL) should be initially measured at fair value minus the transaction costs directly associated with incurring the obligation, so this is no different from recording assets at their acquisition cost. However, subsequent to the date of acquisition, financial liabilities not FVPL are measured at amortized cost using the effective interest method. The effective interest method is discussed in Chapters 7 and 12.

Determining the fair value of longer-term debt obligations is usually fairly straightforward. In many cases, fair (market) values are readily available, as in the case for bonds issued in public markets. Determining the fair value of shorter-term liabilities can be more difficult, though, as normally these types of obligations are not actively traded (e.g., a trade payable to a supplier). Moreover, the time to maturity may be uncertain. Recognizing the inherent difficulties in accurately determining the fair value of short-term obligations, and given that the time value of money is usually immaterial in the short term, accounting standards permit many current obligations to be recognized at their maturing face value.

c. *Non-financial liabilities:* The measurement of non-financial liabilities depends on their nature. For instance, warranties are recorded at management's best estimate of the future cost of meeting the entity's contractual obligations.[4] In comparison, the liability for prepaid magazine subscription costs are valued at the consideration initially received less the amount earned to date through performance. For example, a publisher that received $75 in advance for a three-year subscription and has delivered the magazine for one year would report an obligation of $50 ($75 – $25).

In a somewhat circuitous manner, IFRS provides an exception to the requirement to initially recognize liabilities at fair value and permits many short-term payables to be measured at the undiscounted amount owing (the transaction price). Specifically, IFRS 13 stipulates that:

> ¶37 When a quoted price for the transfer of an identical or a similar liability . . . is not available and the identical item is held by another party as an asset, an entity shall measure the fair value of

---

2. Alternatively, liabilities may be presented in order of liquidity when this style will result in more reliable and relevant information. Financial institutions typically use the liquidity style of presentation.

3. There are certain exceptions to this, as set out in IAS 1 paragraph 71. Discussion of these exclusions is beyond the scope of this text.

4. When the time value of money is material, "best estimate" refers to the present value of the obligation (see IAS 37 Implementation Guidance).

> the liability . . . from the perspective of a market participant that holds the identical item as an asset at the measurement date.[5]

IFRS 9 then establishes that:

> ¶5.1.3 . . . an entity shall measure trade receivables that do not have a significant financing component . . . at their transaction price . . . .[6]

The collective consequence of these two standards follows:

- Because quoted prices for most payables are not available, the debtor should measure the obligations in the same way that the corresponding receivables are measured by the creditor.
- The creditor measures accounts receivables at their transaction price (invoice amount), providing that they do not include a significant financing component.
- The exception applies to trade and many other common payables, as the debtor's payable is (usually) reported as a trade receivable by the creditor.

C. CURRENT LIABILITIES

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

This chapter includes a wide-ranging discussion of accounting for current liabilities (in this section), contingencies (Section D), and guarantees (Section E). Long-term liabilities will be the focus of the next chapter (Chapter 12). Before getting into the specifics, it may be helpful to think of these obligations in terms of the "big picture," specifically:

- Current liabilities arise from past events: the amount to be paid is known or can be reasonably estimated.
- Contingencies arise from past events: the amount to be paid is determined by future events.
- Financial guarantees arise from contracts previously entered into: the amount to be paid is determined by future events.

The focus of this section is current liabilities, several of which are common across almost all entities and a few that are relatively unique. Some of the more universal obligations include trade payables, notes payable, revolving credit facilities, taxes payable, provision for warranties, and deferred revenues. An entity generally uses its **current assets** such as cash to pay its current liabilities when due.

current assets Assets that are expected to be consumed or sold within one year of the balance sheet date or the business's normal operating cycle, whichever is longer. Also includes assets held primarily for trading purposes.

Distinguishing liabilities that are current from those that are long term is important because financial statement users frequently use this information. For instance, financial analysts often use the relationship between a company's current assets and current liabilities in the form of the current ratio (current ratio = current assets ÷ current liabilities) or working capital (working capital = current assets − current liabilities).

The following discussion examines the pertinent features of current liabilities commonly encountered.

1. Trade payables

Trade payables and accruals are obligations to pay for goods received or services used. Trade payables are also commonly called accounts payable or trade accounts payable. Due to processing delays, not all invoices for trade payables will have been received at the end of a year (or another reporting period). In such instances, an enterprise needs to record an "accrued liability" for invoices not yet received but for which the enterprise owes an obligation. Trade payables and accrued liabilities are typically reported as one total on the balance sheet.

trade payables Obligations to pay for goods received or services used.

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