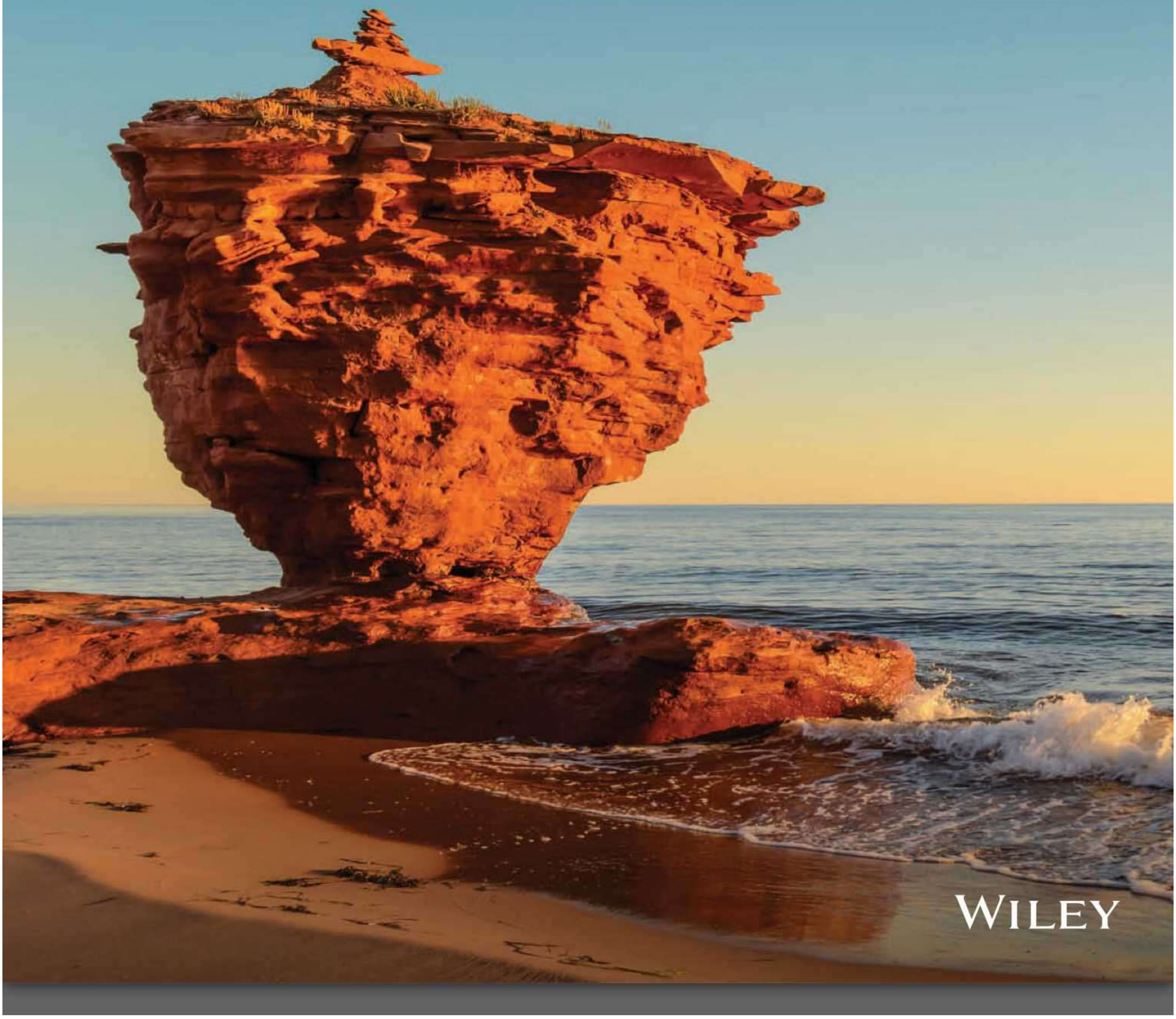
KIESO WEYGANDT WARFIELD WIECEK McCONOMY

INTERMEDIATE ACCOUNTING

Twelfth Canadian Edition

Volume 2



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Intermediate Accounting

Twelfth Canadian Edition

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CHAPTER 13

Non-Financial and Current Liabilities

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Getting a Charge Out of Warranty Accounting

The car business is cutthroat, and one way that auto manufacturers compete is by offering better warranties than their competitors. That's one reason why Tesla Motors, maker of luxury electric vehicles, decided to extend the warranty on its Model S sedan, with a recent base price of U.S. $75,700. In late 2014, Tesla announced that it was extending the warranty on the Model S drive unit from four to eight years, and on the vehicle's battery from four to eight years or 125,000 miles (about 200,000 km) or unlimited miles, depending on the battery size.

Including a warranty on products sold represents a liability to companies because eventually they will have to honour the warranty on some of their products. A warranty is a guarantee by the company that a product will be free of defects for a certain period. Extending the warranty on its Model S vehicle caused Tesla to increase its warranty reserve by U.S. $14.0 million in 2014.

Tesla records a warranty reserve—money it sets aside as an estimate of the costs it will incur to honour the warranty by repairing or replacing any defective items it sells. The warranty reserve "includes our best estimate of the projected costs to repair or replace items under warranty. These estimates are based on actual claims incurred to date and an estimate of the nature, frequency and costs of future claims. These estimates are inherently uncertain given our relatively short history of sales," Tesla says in its 2017 annual report. "The portion of the warranty reserve expected to be incurred within the next 12 months is included within accrued liabilities and other while the remaining balance is included within other long-term liabilities on the consolidated balance sheet." As at December 31, 2017, the company's warranty reserve was U.S. $401.8 million.

If car buyers want to extend their warranties, they can usually pay an extra fee. Tesla offers extended warranties, known as Extended Service Agreements, on its vehicles. When customers buy these service plans, Tesla records the money it receives as deferred revenues, which it then allocates over the service coverage periods. For the year ended December 31, 2017, Tesla had deferred revenues of U.S. $498.9 million from the sale of service plans and other services, such as Internet connectivity and over-the-air software updates.

While Tesla can calculate how much it earns from service plans and spends on honouring warranties, it can't know for certain how much its warranties influence car buyers. Perhaps the company's use of similar extended warranties on its subsequent Model 3 vehicles is one reason why Tesla had waiting lists of eager car buyers.

Sources: "Tesla," Car and Driver, https://www.caranddriver.com/tesla (accessed July 4, 2018); Dana Hull, "Tesla Model 3 Depositors Staying Put as Wait in Line Lengthens," Bloomberg, November 13, 2017; Maria Armental, "Tesla Motors Extends Model S Warranty Retroactively," *The Wall Street Journal*, August 15, 2014; Chuck Jones, "How Much Could Tesla's 'Infinite Mile Warranty' Cost the Company?," Forbes.com, August 18, 2014; Tesla Motors, Inc. 2017 annual report; Tesla Motors, Inc. corporate website, www.teslamotors.com/.

LEARNING OBJECTIVES After studying this chapter, you should be able to:	CHAPTER OUTLINE The chapter headings related to the learning objective are:	CPA COMPETENCIES Competencies addressed by each learning objective are as follows:
1. Understand the importance of non-financial and current liabilities from a business perspective.	**Understanding Non-Financial and Current Liabilities**	**1.1.1, 1.1.2, 1.1.4, 5.2.1**
2. Define liabilities, distinguish financial liabilities from other liabilities, and identify how they are measured.	**Recognition and Measurement** • Liability definition and characteristics • Financial liabilities and non-financial liabilities	**1.2.1, 1.2.2**
3. Define current liabilities and identify and account for common types of current liabilities.	**Common Current Liabilities** • What is a current liability? • Bank indebtedness and credit facilities • Accounts payable • Notes payable • Current maturities of long-term debt • Short-term debt expected to be refinanced • Dividends payable • Rents and royalties payable • Customer advances and deposits • Taxes payable	**1.2.1, 1.2.2, 5.2.1, 6.1.1, 6.2.1**
4. Identify and account for the major types of employee-related liabilities.	**Employee-Related Liabilities** • Payroll deductions • Short-term compensated absences • Profit-sharing and bonus agreements	**1.2.1, 1.2.2**
5. Explain the recognition, measurement, and disclosure requirements for decommissioning and restoration obligations.	**Decommissioning and Restoration Obligations** • Measurement • Recognition and allocation • Subsequent recognition and measurement of asset retirement obligations: Summary	**1.2.1, 1.2.2, 1.2.3**
6. Explain the issues and account for product guarantees, other customer program obligations, and unearned revenue.	**Product Guarantees, Customer Programs, and Unearned Revenue** • Product guarantees and warranty obligations • Other customer program obligations • Unearned revenue	**1.2.1, 1.2.2**

7. Explain and account for contingencies and uncertain commitments, and identify the accounting and reporting requirements for guarantees and commitments.	**Contingencies, Uncertain Commitments, and Requirements for Guarantees and Other Commitments** • Contingencies and uncertain commitments • Financial guarantees • Commitments	**1.1.1, 1.2.1, 1.2.2, 1.3.1, 1.3.2**
8. Indicate how non-financial and current liabilities are presented and analyzed.	**Presentation, Disclosure, and Analysis** • Presentation and disclosure of current liabilities • Presentation and disclosure of contingencies, guarantees, and commitments • Analysis	**1.4.2, 1.4.4, 5.1.1**
9. Identify differences in accounting between IFRS and ASPE, and what changes are expected in the near future.	**IFRS/ASPE Comparison** • A comparison of IFRS and ASPE • Looking ahead	**1.1.4**

Preview of Chapter 13

This chapter explains the basic principles underlying the accounting and reporting for many common current liabilities and for 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. We explain issues related to long-term financial liabilities in Chapter 14.

Understanding Non-Financial and Current Liabilities

LEARNING OBJECTIVE 1

Understand the importance of non-financial and current liabilities from a business perspective.

The asset and liability approach to accounting, as summarized in the conceptual framework, includes asset and liability definitions that relate to the statement of financial position (SFP) but that also affect the statement of comprehensive income. For example, the recognition of an expense often occurs at the same time as the recognition of an increase in a liability or a decrease in an asset. Volume 1 of this text concentrated on the recognition and measurement of a variety of assets. Volume 2 begins with a closer look at liabilities in general and then continues by examining specific types of common liabilities.

The explanations in this chapter about non-financial liabilities under international standards are based on current IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. We provide an overview of potential future revisions to this standard in the Looking Ahead section at the end of the chapter.[1]

There are many kinds of liabilities. As a consumer, a common one you're familiar with is a warranty. When you purchase a new automobile or computer, one major consideration is the length of the warranty provided by the manufacturer or retailer, and whether you should pay an additional amount to extend the warranty. As shown in our feature story about Tesla Motors, from the seller's perspective, the warranty provided to customers represents a liability to be reported on the SFP, or what Tesla calls its consolidated balance sheet. It's considered a liability because the manufacturer or retailer has an obligation to repair or replace any defects that are covered in the warranty, usually for no additional charge. A typical warranty on a new automobile is three years or 60,000 km. As a consumer, you might choose to extend the warranty to five or six years. As a manufacturer or retailer, the warranty you offer will affect your competitive advantage relative to other vendors, and will complicate your accounting over the life of the warranty. We will explore several alternatives for accounting for warranty transactions in this chapter.

Finance 5.2.1 It is important for businesses to properly account for their liabilities so they can keep an eye on their cash flow. Cash flow management is a key control factor for most companies. Taking advantage of supplier discounts for prompt payment is one step companies can take to control their cash flows. Control of expenses and related accounts payable can improve the efficiency of a business, and can be particularly important during economic downturns.

In this chapter, we focus on current liabilities and non-financial liabilities. As we will see, companies need to account for typical items such as trade accounts payable and less obvious liabilities including constructive obligations that arise based on past practice. We look at the related definitions under IFRS and ASPE next before examining the detailed accounting requirements.

Recognition and Measurement

LEARNING OBJECTIVE 2

Define liabilities, distinguish financial liabilities from other liabilities, and identify how they are measured.

Liability Definition and Characteristics

Significant Change Chapter 2 of this text presented the elements of financial statements and their definitions. It explained that the IASB has revised its definitions of terms such as assets and **liabilities** as part of its recently completed conceptual framework project. The new definitions are in the new standard entitled *Conceptual Framework for Financial Reporting* issued in March 2018. In this text, we use the definitions in the new conceptual framework because the IASB started to use it immediately for standard setting, with companies required to use it starting in 2020. **Illustration 13.1** summarizes the definition of liabilities in the new conceptual framework, and under ASPE in the *CPA Canada Handbook*, Part II.[2]

[1]The underlying materials for possible changes to IAS 37 are the January 2010 Exposure Draft Measurement of Liabilities in IAS 37, and a June 2015 Staff Paper on Research—Provisions, Contingent Liabilities, and Contingent Assets (IAS 37).

[2]*CPA Canada Handbook,* Part II, Section 1000.28 and .29; IFRS *Conceptual Framework for Financial Reporting* 4.26–4.47. Copyright © IFRS Foundation. All rights reserved. Reproduced with permission.

ILLUSTRATION 13.1

Definition of Liabilities, IFRS vs. ASPE

Part A: Definition in New IFRS Conceptual Framework (summary)

A **liability** is a present obligation of the entity to transfer an economic resource as a result of past events.

For a liability to exist, the following criteria must all be satisfied:

1. The entity has an obligation (that is, a **present duty or responsibility** to others that it has **no practical ability to avoid**).
2. The obligation is to transfer an economic resource to another party or parties.
3. The obligation exists as a result of past transactions or events.

Part B: ASPE Definition in *CPA Canada Handbook*, Part II (summary)

A liability is an obligation that arises from past transactions or events, which may result in a transfer of assets or provision of services.

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 duty.
3. The transaction or event that obliges the entity has already occurred.

The three criteria to be satisfied are essential to the definition under IFRS.

1. A liability must represent a duty or responsibility; for example, to pay a supplier for goods that it has purchased. The entity has little (or no) ability to avoid the duty or responsibility; otherwise, there could be negative consequences, such as the supplier suing for breach of contract.
2. The liability should have at least the potential to require the transfer of an economic resource such as an obligation to pay cash, deliver goods, provide services, or exchange economic resources with another party on unfavourable terms. The potential transfer of an economic resource does not have to be certain, or even likely, under IFRS—it is "only necessary that the obligation already exists and that, in at least one circumstance, it would require the entity to transfer an economic resource."
3. It should be a present obligation that exists as a result of past events. So, for example, (i) the entity has already obtained economic benefits such as goods or services, or taken an action such as operating a particular business or operating in a particular market and (ii) as a result, the entity will or may have to transfer an economic resource. Under IFRS, a present obligation can exist even if it cannot be enforced until some date in the future. For example, a company may have a contractual liability now, even though it may only be obligated to make a payment in a few months from now.

Similarly, the three characteristics of a liability under the conceptual framework are essential to the current definition under ASPE. (1) A liability must represent a duty or responsibility; for example, to pay a supplier for goods that the entity has purchased. (2) The entity has little (or no) discretion to avoid the obligation. (3) The liability relates to a transaction that has occurred (the goods were purchased, they have been delivered, and title has passed). So an economic obligation exists **at the date of the statement of financial position**.

The existence of an obligation is not always clear, as we will see later in this chapter. For example, there may be uncertainty about whether an event that has occurred results in a present obligation, or how a law or regulation applies to that event. Judgement is needed in many circumstances, with management drawing on evidence such as the entity's past experience, other entities' experience with similar items, and opinions of experts and others.

Law The fact that an entity must have a duty or responsibility to perform in a particular way suggests that it must bear an economic obligation, and this requirement can be **enforced by legal or equivalent means**. This means that a law, a contract enforceable by law, or a constructive obligation exists. A **constructive obligation** arises when past or present company practice shows that the entity acknowledges a potential economic burden. This comes about because the entity has indicated to others that it will accept a specific responsibility and other

parties can reasonably expect the entity to meet its responsibility. For example, a company may be required by provincial legislation to provide 4% vacation pay to its employees, but it may have paid 6% over the past number of years. Therefore, even though the company may not be required by law or contract to pay the extra 2 percentage points, the expectation is that it will continue to do so. Therefore, a constructive obligation exists, and amounts owing at the date of the SFP are recognized as a liability, based on the amount of 6%.

All entities must also comply with the statutes, laws, and regulations in the legal jurisdiction in which they operate; however, these result in liabilities only if the entity violates their provisions. A liability does not result if the transaction or event obliging the company has not yet taken place.

Under current ASPE (and IFRS before the new conceptual framework) **recognition** requirements, non-financial liabilities are recognized only if it is probable (that is, more likely than not) that the obligation would result in an outflow of cash or other economic resources from the entity. That is, the uncertainty of the amount is a factor in determining whether the obligation is recognized as a liability.

Financial Liabilities and Non-Financial Liabilities

IFRS ASPE Because a number of accounting standards refer to the recognition, measurement, and reporting of **financial instruments** specifically, it is important to be able to identify those that are **financial liabilities**. Under accounting standards both for private enterprises (ASPE) and IFRS, a **financial liability** is any liability that is a **contractual obligation**:

1. to deliver cash or other financial assets to another entity, or
2. to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity.[3]

Note that this definition requires the liability to be based on an obligation that is created by a contract. Liabilities that are created by legislation, such as income taxes payable, do not qualify as financial liabilities and therefore are not covered by the same accounting standards as financial liabilities. In this chapter, most current liabilities are financial in nature, but if the obligation will be met by the delivery of goods or services, such as in the case of unearned revenue and warranty obligations, it is not considered a financial liability.

The classification of liabilities into financial and non-financial liabilities is important because the accounting standard that applies depends on how the liability is classified. See **Underlying Concept 13.1**.

Underlying Concept 13.1

To be able to properly classify specific financial instruments, proper definitions are needed for assets, liabilities, and equities. The conceptual framework definitions are used as the basis for settling difficult classification issues.

Measurement

Financial Liabilities Financial liabilities are recognized initially at their fair value. After acquisition, though, most of the financial liabilities that are discussed in this and later chapters are accounted for **at their amortized cost**.[4] Consistent with cost-based measurement, the original fair value of a financial liability is generally adjusted for transaction costs that are directly attributable to the issue of the financial liability (to defer the difference between fair value and the transaction price). However, transaction costs associated with the issue of financial liabilities that are accounted for after acquisition at fair value through profit or loss are recognized in net income as incurred.

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[3]IAS 32 *Financial Instruments: Presentation,* para. 11. Copyright © IFRS Foundation. All rights reserved. Reproduced with permission.

IAS 32.11 also discusses instances where a financial liability is a contract that may be settled in the entity's own equity instruments. See also *CPA Canada Handbook,* Part II, Section 3856.05 for similar ASPE requirements. Reprinted/adapted with permission from the CPA Canada Handbook—Accounting © 2018, Part II by Chartered Professional Accountants of Canada. All rights reserved by the copyright owner.

[4]For purposes of intermediate financial accounting, financial liabilities at fair value through profit or loss accounted for at fair value include derivatives and other financial liabilities accounted for using the fair value option. We discuss these financial liabilities further in Chapters 14, 15, and 16.

When liabilities are short-term in nature, such as regular trade payables with 30- or 60-day payment terms, they are usually accounted for, on practical grounds, at their maturity value. This is appropriate because the difference between the liability's fair value and its maturity value is not significant. The slight overstatement of liabilities that results from carrying many current liabilities at their maturity value is accepted if it is immaterial.

Non-Financial Liabilities ASPE Non-financial liabilities, on the other hand, are usually not payable in cash. Therefore, they are measured in a different way. ASPE does not separately address the issue of non-financial liabilities, so these are measured in a variety of ways, depending on the specific liability. For example, unearned revenue is usually measured at the fair value of the goods or services to be delivered in the future.

IFRS Under IFRS, many 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 date of the SFP to settle the present obligation. Items such as assurance warranties are often measured at the expected value or probability-weighted average of the range of possible outcomes.[5] Other examples include obligations related to the dismantling and retirement of assets. These are referred to under IFRS as **provisions**: liabilities of uncertain timing or amount.

Non-financial liabilities are generally more difficult to measure than financial liabilities because the obligations will be met with goods and services (that is, non-financial resources), and the timing of meeting the obligation and its amount are not fixed. Examples from IFRS 15 include unearned revenue (including unearned revenue related to service warranties) and obligations under customer loyalty programs, which are discussed in Chapter 6.

Even though the exact amount and timing of these obligations may not be known, whenever they involve unconditional obligations that are enforceable and that exist at the date of the SFP, they are liabilities. Another way to distinguish between financial and non-financial liabilities is how they are measured. We return to this issue later in the chapter where we review two such obligations where there is little or no uncertainty about the existence of the liability, although there may be uncertainty about its measurement (that is, decommissioning and restoration obligations, and unearned revenue).

With this introduction to liabilities, we now take a closer look at specific current liabilities found on most companies' statements of financial position.

Common Current Liabilities

LEARNING OBJECTIVE 3

Define current liabilities and identify and account for common types of current liabilities.

What Is a Current Liability?

Because liabilities result in a future disbursement (payment) of assets or services, one of their most important features is the timing of when they are due. Obligations that mature in the short term place a demand on the entity's current assets. They are demands that must be satisfied on time and in the ordinary course of business if operations are to continue. Liabilities

[5] IAS 37 also addresses the issue of possible reimbursements that apply when an entity settles a *provision*. In this case, a reimbursement must be virtually certain of being received, so there may be timing differences between when a non-financial liability is recognized and when the corresponding recovery is recognized. See IAS 37.36 - IAS 37.39 and IAS 37.53 for further details.

with a distant due date generally do not result in a claim on the company's current assets and are therefore classified differently. This difference in timing and the effect on current assets is a major reason for the division of liabilities into (1) current liabilities and (2) non-current liabilities.

Another reason for classifying current assets and liabilities separately from long-term assets and liabilities is to provide information about the working capital used by the entity in its normal operating cycle. The normal **operating cycle** is the period of time between acquiring the goods and services for processing in operations and receiving cash from the eventual sale of the processed goods and services. Industries that manufacture products that go through an aging process, and certain capital-intensive industries, may have an operating cycle of much longer than one year. On the other hand, most retail and service establishments have several operating cycles in a single year. The operating cycle is sometimes called the cash-to-cash cycle. If the length of the cycle is not obvious, accounting standards typically assume it is 12 months or less.

The definition of a **current liability** and of the length of the operating cycle is directly related to that of a current asset. A liability is classified as current under IFRS when one of the following conditions is 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 date of the statement of financial position.[6]

ASPE provides a similar definition, suggesting that current liabilities include amounts payable within one year from the date of the balance sheet or within the normal operating cycle, when that is longer than a year.[7] There may be minor differences in application.

We will now illustrate a variety of current liabilities commonly found in companies' financial statements.

Bank Indebtedness and Credit Facilities

Finance 5.2.1 A major element of a company's liquidity position is its bank indebtedness for current operating purposes and its **line of credit** or **revolving debt** arrangements related to this debt. Instead of having to negotiate a new loan every time it needs funds, a company generally enters into an agreement with its bank that allows it to make multiple borrowings up to a negotiated limit. As previous borrowings are partly repaid, the company is allowed to borrow again under the same contract. Because the financial institution commits itself to making money available to the entity, the bank often charges an additional fee for this service over and above the interest that it charges on the funds that are actually advanced. Under such agreements, the financial institution usually requires collateral and often sets restrictions on the company's activities or financial statement ratios that must be maintained.

The amount of actual bank indebtedness is reported on the SFP, and any restrictions that are imposed by the financial institution are disclosed in the notes. See **What Do the Numbers Mean? 13.1**. Some companies also choose to disclose details of their lines of credit, as these lines help manage liquidity risk (IFRS 7.39).

[6]IAS 1.69 *Presentation of Financial Statements*. The IASB decided at their November 15, 2018, meeting to clarify in IAS 1 that a company's right to defer settlement of a liability is not affected by whether management expects to use the right. It is also not affected by whether the liability was settled subsequent to the year-end date, and prior to the SPF being authorized for issue. Copyright © IFRS Foundation. All rights reserved. Reproduced with permission.

[7]Reprinted/adapted with permission from the CPA Canada Handbook—Accounting © 2018, Part II, Section 1510.08 to 1510.11, by Chartered Professional Accountants of Canada. All rights reserved by the copyright owner.

What Do the Numbers Mean? 13.1

Borrowings and growth must be carefully managed! Maintaining close working relationships with customers, banks, suppliers, and other creditors is central to getting through a cash crunch. Based in Arnprior, Ontario, **Pacific Safety Products Inc.** (PSP) enjoyed a 69% increase in sales in one year several years ago and suffered the liquidity problems that often come with such success. The company's annual report indicated that one of PSP's major challenges during the year had been to manage its cash flow so that it could pay suppliers. It had to ensure a continuous flow of raw materials needed for manufacturing in order to meet customer orders on a timely basis.

PSP reported bank indebtedness of almost $3 million in its current liabilities at the company's year end. Providing details on the indebtedness, a note to the financial statements showed a maximum operating line of credit of $3 million with the Bank of Nova Scotia, which was secured by accounts receivable, inventory, and an assignment of insurance. The note also reported that the company was not in compliance with the covenants imposed by the bank for its current ratio and tangible net worth, but that the bank was allowing PSP to operate outside its covenants.

One year later, PSP reported sales that were only 75% of those reported for the preceding fiscal year, but its cash flow from operating activities was almost twice as high! The uncollected receivables from one year earlier had been collected and this allowed the company to get over its cash crunch. Bank indebtedness was reduced to only $102,417, the operating line was reduced to $2 million, and the company was once again in compliance with the bank's covenants.

Accounts Payable

Accounts payable, or **trade accounts payable**, are balances owed to others for goods, supplies, or services related to the entity's ordinary business activities that are purchased on open account. This means that evidence of the obligations' existence comes from regular invoices rather than from separate contracts for each transaction. Accounts payable arise because of the time lag between the receipt of goods and services and the payment for them. This period of extended credit is usually stated in the terms of sale and purchase; for example, 2/10, n/30 or 1/10, E.O.M., net 30. The period is commonly 30 to 60 days long.[8]

Most accounting systems are designed to record liabilities for purchases of goods when the goods are received. Sometimes there is a delay in recording the goods and the related liability on the books, such as when waiting for an invoice. If title has passed to the purchaser before the goods are received, the transaction should be recorded when the title passes. Attention must be paid to transactions that occur near the end of one accounting period and the beginning of the next so that the goods and services received (the inventory or expense) are recorded in the same accounting period as the liability (accounts payable) and both are recorded in the proper period. Chapter 8 discussed this cut-off issue in greater detail and illustrated the entries for accounts payable and purchase discounts.

Notes Payable

Law **Notes payable** are written promises to pay a certain sum of money on a specified future date and may arise from purchases, financing, or other transactions. In some industries, instead of the normal procedure of extending credit on an open account, notes (often called **trade notes payable**) are required as part of the sale or purchase transaction. Notes payable to banks or loan companies are generally created by cash loans. Notes may be classified as current (short-term) or long-term (non-current), depending on the payment due date. Notes may also be interest-bearing or non–interest-bearing (that is, zero-interest-bearing). Accounting for them is the mirror image of accounting for notes receivable illustrated in Chapter 7, as we show in **Example 13.1** and **Example 13.2**.

[8] As explained in Chapter 7, 2/10, n/30 means there is a 2% discount if the invoice is paid within 10 days, with the full amount due in 30 days; and 1/10, E.O.M., net 30 means that there is a 1% discount if the invoice is paid before the 10th day of the following month with full payment due by the 30th day of the following month. (E.O.M. is "end of month.")

Interest-Bearing Note Issued

Example 13.1 | Accounting for an Interest-Bearing Note

Facts Assume that Provincial Bank agrees to lend $100,000 to Landscape Corp. on March 1, 2020 and the company signs a $100,000, four-month, 12% note maturing on July 1, 2020.

Instructions Prepare the journal entry to record the cash received by Landscape Corp. on March 1, the entry to record interest expense at June 30 (at the date of Landscape's semi-annual financial statements), and the entry at maturity of the note.

Solution The journal entry to record the cash received by Landscape Corp. on March 1 is as follows:

March 1	Cash	100,000	
	Notes Payable		100,000

If Landscape Corp. has a December 31 year end, but prepares financial statements semi-annually, the adjusting entry to recognize the four months of interest expense and interest payable of $4,000 ($100,000 × 12% × 4/12) on June 30 is:

June 30	Interest Expense	4,000	
	Interest Payable		4,000

At maturity on July 1, Landscape Corp. pays the note's face value of $100,000 plus the $4,000 of interest. The entry to record payment of the note and accrued interest is as follows:

July 1	Notes Payable	100,000	
	Interest Payable	4,000	
	Cash		104,000

A	=	L	+	SE
+100,000		+100,000		

Cash flows: ↑ 100,000 inflow

A	=	L	+	SE
		+4,000		−4,000

Cash flows: No effect

A	=	L	+	SE
−104,000		−104,000		

Cash flows: ↓ 104,000 outflow

Zero-Interest-Bearing Note Issued

A zero-interest-bearing note may be issued instead of an interest-bearing note. Despite its name, a **zero-interest-bearing note does have an interest component**. The interest is just not added on top of the note's face or maturity value; instead, it is included in the face amount. The interest is the difference between the amount of cash received when the note is signed and the higher face amount that is payable at maturity. The borrower receives the note's present value in cash and pays back the larger maturity value.

Example 13.2 | Accounting for a Zero-Interest-Bearing Note

Facts Similar to Example 13.1, assume that Landscape Corp. issues a $100,000, four-month note payable to the Provincial Bank on March 1. However, assume that it is a zero-interest-bearing note with a present value of $96,154, based on the bank's discount rate of 12%.

Instructions Prepare the journal entry to record the cash received by Landscape on March 1, the entry to record interest expense at June 30, and the entry at maturity of the note. Provide details of the related calculations and/or discuss the amounts used in your journal entries.

Solution Landscape's entries to record these transactions are as follows:

March 1	Cash	96,154	
	Notes Payable[9]		96,154

A	=	L	+	SE
+96,154		+96,154		

Cash flows: ↑ 96,154 inflow

[9]Alternatively, the note payable could have been recorded at its face value of $100,000, with the $3,846 difference between the cash received and the face value debited to Discount on Notes Payable. Discount on Notes Payable is a contra account to Notes Payable and therefore would be subtracted from Notes Payable on the statement of financial position. For simplicity, we do not use an account for discounts, or premiums, on notes or bonds payable in this text.

Notes Payable is credited for the note's fair value, which is less than the cash due at maturity. In effect, this is the amount borrowed. If Landscape Corp. prepares financial statements at June 30, the interest expense for the four-month period to June 30 must be recognized along with the increase in the Note Payable, $\$96{,}154 \times 12\% \times {}^{4}/_{12} = \$3{,}846$, as follows:

June 30	Interest Expense	3,846	
	Notes Payable		3,846

The Notes Payable account would now have a balance of $\$96{,}154 + \$3{,}846 = \$100{,}000$. This is the amount borrowed plus interest to June 30 at 12%. On July 1 the note is repaid:

July 1	Notes Payable	100,000	
	Cash		100,000

A	=	L	+	SE
		+3,846		−3,846

Cash flows: No effect

A	=	L	+	SE
−100,000		−100,000		

Cash flows: ↓ 100,000 outflow

We discuss the accounting issues of long-term notes payable in Chapter 14.

Current Maturities of Long-Term Debt

Bonds, mortgage notes, and other long-term indebtedness that mature within 12 months from the date of the SFP—**current maturities of long-term debt**—are reported as current liabilities. What if only part of a long-term obligation is to be paid within the next 12 months, as in the case of a mortgage or of serial bonds that are to be retired through a series of annual instalments? In that case, **only the maturing portion of the principal of the long-term debt is reported as a current liability**. The balance of the principal is reported as a long-term liability.

Portions of long-term obligations that will mature in the next 12 months should not be included as current liabilities if, by contract, they are to be retired by assets accumulated for this purpose that properly have not been reported as current assets. In this situation, no current assets are used and no other current liabilities are created in order to repay the maturing liability. Therefore, it is correct to classify the liability as long-term.

Law A liability that is **due on demand** (that is, callable by the creditor), or that will be due on demand within a year, is also classified as a current liability. Often companies have debt agreements that, while due on demand, have payment schedules set up to pay the obligation over a number of years. The management of these entities may argue that only the portion due to be paid within 12 months should be classified as current. Managers may also argue that financial statement readers will be misled if the whole of the debt is reported as a current liability, because the company's liquidity position is misrepresented. The standard setters, on the other hand, indicate that all of such **callable debt** meets the definition of a current liability, and that additional information about the callable debt can be explained in the notes to the financial statements.

Liabilities often become callable by the creditor if there is a violation of a debt agreement. For example, most debt agreements require the borrower to maintain a minimum ratio of equity to debt or, as illustrated in the Pacific Safety Products situation in What Do the Numbers Mean? 13.1, specify minimum current ratio requirements.

IFRS ASPE If a long-term debt agreement is violated and the liability becomes payable on demand, the debt is reclassified as current. Under IFRS, this position holds, even if the lender agrees between the date of the SFP and the date the financial statements are released that it will not demand repayment because of the violation. This position is consistent with the fact that, at the date of the SFP, the entity did not have an unconditional right to defer the payment beyond 12 months from the reporting date. That right could only be exercised by the lender.

Under ASPE, the liability is reclassified to the current category unless:

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

and it is not likely that the company will violate the covenant requirements within a year from the date of the SFP.[10]

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Short-Term Debt Expected to Be Refinanced

Short-term debt obligations are amounts scheduled to mature within one year from the date of the SFP. However, a classification issue arises when such a liability is expected to be refinanced on a long-term basis, and therefore current assets are not expected to be needed for it. Where should these **short-term obligations expected to be refinanced** on a long-term basis be reported?[11]

At one time, the accounting profession generally agreed with not including short-term obligations in current liabilities if they were "expected to be refinanced" on a long-term basis. Because the profession gave no specific guidelines, however, determining whether a short-term obligation was expected to be refinanced was usually based solely on management's **intent**. Classification was not clear-cut and the proper accounting was therefore uncertain. For example, a company might want a five-year bank loan but handle the actual financing with 90-day notes that it keeps renewing. In this case, is the loan long-term debt or a current liability?

IFRS Consistent with the international standard for callable debt, under IFRS, if the debt is due within 12 months from the reporting date, it is classified as a current liability. This classification holds even if a long-term refinancing has been completed before the financial statements are released. The only exception accepted for continuing long-term classification is if, at the date of the SFP, 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**.

ASPE Also consistent with the ASPE standard for callable debt, the short-term liability expected to be refinanced is classified as a current liability. That is the case unless either 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. In other words, if there is irrefutable evidence by the time the financial statements are completed that the debt has been or will be converted into a long-term obligation, ASPE allows currently maturing debt to be classified as long-term on the balance sheet.

If an actual refinancing occurs, the amount of the short-term obligation that is excluded from current liabilities under ASPE cannot be higher than the proceeds from the new obligation or equity securities that are used to retire it, as shown in **Example 13.3**.

Example 13.3 | Refinancing of Short-Term Debt

Facts Assume that Montavon Winery has $3 million of short-term debt at the reporting date. The company then issues $2 million of long-term debt after the balance sheet date but before the financial statements are issued.

Instructions IFRS ASPE

a. How should Montavon classify its short-term debt if it follows ASPE, assuming it uses the proceeds from the long-term debt issue to liquidate $2 million of the short-term liability?

b. How would your response change if Montavon followed IFRS?

c. Which set of standards is more stringent?

Solution

a. Under ASPE, if the net proceeds from the issue of the new long-term debt total $2 million, only $2 million of the short-term debt can be excluded from current liabilities.

b. Under IFRS, the whole $3 million of maturing debt would still be classified as a current obligation.

c. Therefore, the international standard has a more stringent requirement: the agreement must be in place **at the date of the SFP**.

[11] Refinancing a short-term obligation on a long-term basis means either (1) replacing it with a long-term *obligation* or with equity securities or (2) renewing, extending, or replacing it with short-term obligations for an uninterrupted period that is more than one year from the date of the balance sheet.

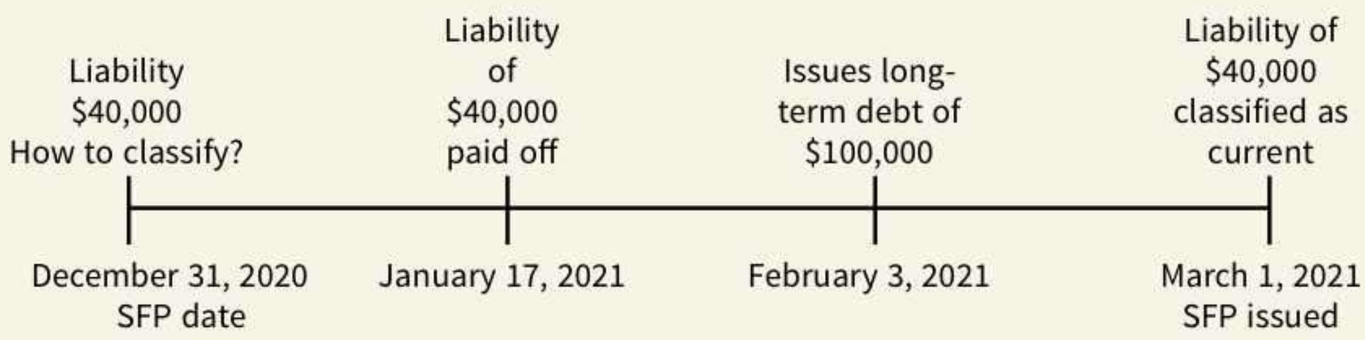
Another issue is whether a short-term obligation can be excluded from current liabilities if it is paid off after the date of the SFP and then replaced by long-term debt before the financial statements are issued, as shown in **Example 13.4**.

Example 13.4 | Repayment of Short-Term Debt Prior to SFP Issuance

Facts Assume that Marquardt Limited pays off short-term debt of $40,000 on January 17, 2021, and issues long-term debt of $100,000 on February 3, 2021. Marquardt's financial statements dated December 31, 2020, are issued on March 1, 2021.

Instructions How would the short-term debt of $40,000 be classified on Marquardt's December 31, 2020 financial statements under ASPE and under IFRS? Use a chart to illustrate the timeline for your response.

Solution Because the refinancing does not appear to be linked to the short-term debt, both ASPE and IFRS require the debt to be classified as current. In addition, because its repayment occurred **before** funds were obtained through long-term financing, the repayment **used existing** current assets. The following chart illustrates the timeline:



Dividends Payable

A cash **dividend payable** is an amount that a corporation owes to its shareholders because the board of directors has authorized a dividend payment. At the dividend declaration date, the corporation incurs a liability that places the shareholders in the position of creditors for the amount of dividend declared. Because cash dividends are normally paid within one year of the declaration (generally within three months in actual practice), they are classified as current liabilities.

Accumulated but undeclared dividends on cumulative preferred shares **are not recognized as a liability**, because **preferred dividends in arrears** are not an obligation until formal action is taken by the board of directors to authorize the distribution. See **Underlying Concept 13.2**. Nevertheless, the company is required to disclose the existence of cumulative dividends in arrears that are undeclared in a note to the financial statements.

Dividends that are payable in the form of additional shares **are not recognized as a liability**. Such share or stock dividends (discussed further in Chapter 15) do not meet the definition of a liability because they do not require future outlays of economic resources. In addition, they are not enforceable in that the board of directors can revoke them at any time before they are issued. On declaration, an entry is prepared that reduces (debits) Retained Earnings and credits a contributed capital account such as Stock Dividends Distributable. This latter account is reported in the shareholders' equity section because it represents a transfer of equity from retained earnings to contributed capital.

Underlying Concept 13.2

Preferred dividends in arrears are economic obligations for which the entity is the obligor, but they are not present obligations until declared. Using a note to disclose the preferred dividends in arrears improves the predictive value of the financial statements.

Rents and Royalties Payable

Law Rents and royalties payable is another common type of current liability. This obligation may be created by a **contractual agreement in which payments are conditional on the amount of revenue that is earned or the quantity of product that is produced or extracted**. For example, franchisees are usually required to pay franchise fees to the franchisor that are calculated as a percentage of sales. Tenants in shopping centres may be obligated to

pay additional rents on sales that are above a predetermined amount. Manufacturers may have licensing agreements that require them to pay the holder of a patent a royalty for each unit that the manufacturer produces.

Liabilities for expenses that are based on revenues earned or units produced are usually easy to measure. For example, if a lease calls for a fixed rent payment of $500 per month and 1% of all sales over $300,000 per year, the annual rent obligation amounts to $6,000 plus $0.01 for each dollar of revenue over $300,000. Or a royalty agreement may require the accrual of $1 per unit that is produced under a patented process, or the accrual of $0.50 on every barrel of oil that is extracted, with the accrued amount then paid to the owner of the mineral rights. As each additional unit of product is produced or extracted, an additional obligation, usually a current liability, is created or increased.

Customer Advances and Deposits

A company's current liabilities may include **returnable cash deposits** or **customer advances** that are received from customers and employees. Deposits may be received from customers to guarantee the performance of a contract or service or to guarantee the payment of expected future obligations. For example, cable television companies often require advance payments from customers when they install a cable connection. Some companies require their employees to make deposits for the return of keys or other company property. Deposits may also be received from tenants to cover possible future damage to property or by carmakers like Tesla for buyers on a waiting list for a new car.

Are the deposits current or long-term obligations? Their initial classification depends on the conditions attached to the specific deposit. For example, if the entity does not have the right to defer the settlement of the deposit for a period in excess of 12 months from the date of the SFP, the deposit is reported as a current liability.

Taxes Payable

Sales Tax

Provincial sales taxes on transfers of tangible property and on certain services must be collected from customers and remitted to the tax authority, usually a provincial or territorial government.[12] The balance in the Sales Tax Payable account is the liability for sales taxes that have been collected from customers but not yet remitted to the appropriate government. The following entry shows the accounting for a sale on account of $3,000 when a 7% sales tax is in effect:

Accounts Receivable	3,210	
Sales Revenue		3,000
Sales Tax Payable		210

A	=	L	+	SE
+3,210		+210		+3,000

Cash flows: No effect

Goods and Services Tax

Taxation 6.1.1 Most businesses in Canada are subject to the Goods and Services Tax (GST). The GST, a **value-added tax** of 5% (since July 1, 2008), is a tax on the value added to the goods and services provided by each taxable entity. The net amount that an entity pays to the Canada Revenue Agency (CRA), which administers this tax, is determined as follows. The entity deducts its **input tax credit** (the GST the company paid on goods and services it purchased from suppliers) from the amount of GST the company collected, on behalf of the government, on sales to its customers. The Harmonized Sales Tax (HST) is accounted for **in the same way** as the GST in those provinces that have agreed on the combined provincial tax and GST.[13]

[12]The rate of provincial sales tax (PST) varies from province to province. When this text went to print, Alberta and the territories had no sales tax, while Quebec's rate was 9.975%, Manitoba's rate was 8%, British Columbia's was 7%, and Saskatchewan charged 6%. The tax is usually applied to the sale amount. As discussed below, in Ontario and the Atlantic provinces, the PST and GST have been combined into a Harmonized Sales Tax (HST) ranging from 13% to 15%.

[13]In Ontario, New Brunswick, Newfoundland and Labrador, Prince Edward Island, and Nova Scotia, the provincial retail sales tax has been combined with the federal Goods and Services Tax (5%) to form the HST. The 13% HST (15% in the Atlantic provinces) is administered for the most part by the Canada Revenue Agency and is accounted for on the same basis as the GST for the other provinces and territories. In Quebec, both the Quebec Sales Tax and the GST are administered by the province.

Accounting for the GST involves setting up a liability account—GST Payable—that is credited with GST charged on sales, and an asset account—GST Receivable—that is debited for GST paid to suppliers. Normally, the amount that is collected on sales is higher than the amount paid on purchases, and a net remittance is therefore made to the Canada Revenue Agency. Since GST is also paid on purchases of capital assets, it is possible for the GST Receivable account to have a larger balance. In these instances, a claim for reimbursement is made to the CRA.

Let's look at the accounting for the GST. Purchases of taxable goods and services are recorded by debiting the GST Receivable account for the amount of GST to be paid and debiting the appropriate asset or expense account(s) for the purchase price. As shown in **Example 13.5**, since the GST paid is recoverable from the federal government, it is not included in the cost of the item(s) acquired.

Example 13.5 | Accounting for Purchase of Merchandise Plus GST

Facts Assume that Bateman Limited purchases merchandise for $150,000 plus GST of 5% ($7,500). The goods are later sold for $210,000 plus GST of 5% ($10,500).

Instructions Prepare the journal entries to record the purchase of merchandise by Bateman and the subsequent sale to one of its customers.

Solution The entry to record the purchase transaction is as follows, assuming a perpetual inventory system is used:

Inventory	150,000	
GST Receivable	7,500	
Accounts Payable		157,500

A	=	L	+	SE
+157,500		+157,500		

Cash flows: No effect

If these goods are then sold for $210,000 plus GST of 5% ($10,500), the sale entry is:

Accounts Receivable	220,500	
Sales Revenue		210,000
GST Payable		10,500

A	=	L	+	SE
+220,500		+10,500		+210,000

Cash flows: No effect

In many cases, GST and provincial sales taxes (PST) are levied on the same sale and purchase, as demonstrated in **Example 13.6.**

Example 13.6 | Accounting for PST and GST

Facts Assume that Smith Ltd. sells supplies to Jones Corp. for $1,000 and both a 7% provincial sales tax and 5% GST are charged on this amount.

Instructions Prepare the journal entries to record the sale of supplies by Smith and the related purchase by Jones including the impact of GST and PST on the transactions.

Solution The entry made by each company follows:

Smith Ltd. (vendor company)			Jones Corp. (purchaser company)		
Accounts Receivable	1,120		Supplies Expense	1,070	
Sales Revenue		1,000	GST Receivable	50	
Sales Tax Payable		70	Accounts Payable		1,120
GST Payable		50	(To record purchase from Smith Ltd.)		
(To record sale to Jones Corp.)					

For vendor

A	=	L	+	SE
+1,120		+120		+1,000

Cash flows: No effect

For purchaser

A	=	L	+	SE
+50		+1,120		−1,070

Cash flows: No effect

Notice in Example 13.6 that the purchaser includes the provincial sales tax **in the cost** of the goods or services purchased. The provincial sales tax, unlike the GST, is not recoverable by the purchaser.[14] In the provinces with a Harmonized Sales Tax, the full HST amount is treated as shown for the GST.

[14]One exception is in the province of Quebec, where for the Quebec Sales Tax, like the GST, all amounts paid are recoverable by the entity through a system of input tax refunds, similar to the input tax credits for the GST.

Law Because companies are allowed by law to offset the GST receivable and payable amounts, only the net balance of the two accounts is reported on the SFP. Until a net credit balance is remitted to the Receiver General for Canada, it is reported as a current liability. A net debit balance, on the other hand, is reported as a current asset.

Income Tax

Taxation 6.1.1 In Canada, federal and provincial income taxes are levied on a company's taxable income. Most businesses consider the amount of income tax payable as an estimate because corporate tax returns are often finalized after the financial statements have been issued. In addition, the meaning and application of numerous tax rules, especially new ones, are debatable and often depend on a court's interpretation. Using the best information and advice available, a business prepares its income tax return at the end of its fiscal year and calculates its best estimate of the income tax payable for the period. Most corporations are required to make periodic tax instalments (payments) throughout the year based on the previous year's income tax or estimates of the current year's income tax, as illustrated in **Example 13.7**.

Example 13.7 | Accounting for Income Taxes Payable

Facts Assume that Forest Ltd. determines, based on its taxable income for the year, that an income tax liability of $21,000 is payable, and further assume that no accruals or instalments have been made during the year.

Instructions

a. What journal entry would Forest make at year end?

b. How would your response change if Forest also made a $20,000 tax instalment at the end of the year?

c. How would this instalment be shown on Forest's SFP? How would the financial statement presentation change if Forest's instalments totalled $23,000 instead of $20,000?

Solution

a. Forest would make the following entry at year end:

Current Tax Expense	21,000	
Income Tax Payable		21,000

A	=	L	+	SE
		+21,000		−21,000

Cash flows: No effect

b. If Forest Ltd. made a $20,000 tax instalment at the end of the year, the following entry would also have been made:

Income Tax Payable	20,000	
Cash		20,000

A	=	L	+	SE
−20,000		−20,000		

Cash flows: ↓ 20,000 outflow

c. Taking into account the $21,000 tax liability from above, Forest Ltd. would report an Income Tax Payable balance of $1,000 in the current liabilities section of its year-end SFP ($21,000 − $20,000). Alternatively, if the company had made instalments of $23,000, there would be a $2,000 debit balance in the Income Tax Payable account ($23,000 − $21,000). This would be reported as Income Tax Receivable, a current asset.

An alternative approach that is often used charges (debits) the instalment payments to expense. When the tax return is completed at year end and the actual amount of tax for the year is calculated, the expense is then adjusted. **Example 13.8** illustrates this series of entries.

Example 13.8 | Accounting for Income Taxes Payable

Facts Consistent with Example 13.7, assume that Forest Ltd. makes instalment payments of either $20,000 or $23,000. Forest then determines, based on its taxable income for the year, that an income tax liability of $21,000 is payable for the year.

Instructions

a. If Forest uses the approach that charges the instalment payments to expense initially, what journal entry would Forest make for its instalments of $20,000 (or $23,000 under a second scenario)?

b. What adjusting entry would be required at year end if actual taxes payable for the year were $21,000?

Solution The following journal entries would be made under the two scenarios:

a. Instalment payments of $20,000

Current Tax Expense	20,000	
Cash		20,000

Instalment payments of $23,000

Current Tax Expense	23,000	
Cash		23,000

b. Adjusting entry if income taxes per tax return = $21,000

Current Tax Expense	1,000	
Income Tax Payable		1,000

Adjusting entry if income taxes per tax return = $21,000

Income Tax Receivable	2,000	
Current Tax Expense		2,000

Regardless of the approach used, the resulting Current Tax Expense is identical.

If the CRA assesses an additional tax on an earlier year's income, Income Tax Payable is credited and the Current Tax Expense is usually charged to current operations as a change in estimate. However, if, for example, the additional tax was caused by an obvious arithmetic error that occurred when the tax was originally calculated, the error would be corrected through retained earnings.

It is common for there to be differences between taxable income **under the tax laws** and accounting income **under generally accepted accounting principles**. Because of these differences, the total income tax payable to the government in any specific year may differ substantially from the total income tax expense reported on the financial statements. Chapter 18 focuses on the problems of accounting for income tax and presents an extensive discussion of related issues that are both complex and interesting.

Taxation 6.2.1 Unlike corporations, proprietorships and partnerships are not taxable entities. It is the individual proprietor and the members of a partnership, not the business itself, that are subject to personal income taxes on their share of the business's taxable income. Therefore, income tax liabilities do not appear on the financial statements of proprietorships and partnerships.

Employee-Related Liabilities

LEARNING OBJECTIVE 4

Identify and account for the major types of employee-related liabilities.

Amounts that are owed to employees for salaries or wages at the end of an accounting period are a common current liability, often called Salaries and Wages Payable. The following items related to employee compensation are also usually reported as current liabilities:

1. Payroll deductions
2. Short-term compensated absences
3. Profit-sharing and bonuses

Payroll Deductions

The most common types of **payroll deductions** are employee income taxes, Canada (or Quebec) Pension Plan contributions, Employment Insurance premiums, and miscellaneous items such as other insurance premiums, employee savings, and union dues. Any amounts that have been deducted but not yet remitted to the proper authority by the end of the accounting period are recognized as current liabilities. This is also true for any matching amounts that the employer is required to pay.

Canada (Quebec) Pension Plan

Law The Canada Pension Plan (CPP) and Quebec Pension Plan (QPP) are financed by the governments through a tax on both the employer and the employee. All employers are required to collect the employee's share of this tax. They deduct it from the employee's gross pay and remit it regularly to the government along with the employer's share. Both the employer and the employee are taxed at the same rate (which was 4.95% each in 2018) based on the employee's gross pay up to maximum contributory earnings of $52,400. This maximum amount is determined by subtracting the basic yearly exemption of $3,500 from the maximum amount of pensionable earnings of $55,900. The maximum annual contribution for each of the employee and employer was therefore 4.95% of $52,400, or $2,593.80 in 2018.

Employment Insurance

Another payroll tax that the federal government levies on both employees and employers is Employment Insurance (EI). Employees must pay an EI premium of 1.66% (2018) of insurable earnings to an annual maximum contribution of $858.22. The employer is required to contribute 2.324% or 1.4 times the amount of employee premiums.[15] Insurable earnings are gross wages above a preset minimum and below a maximum amount of $51,700. Both the premium rates and insurable earnings are adjusted periodically.

Income Tax Withholding

Income tax laws require employers to withhold from each employee's pay the approximate amount of income tax that will be due on those wages. The amount of income tax that is withheld is calculated by the employer according to a government-prescribed formula or a government-provided income tax deduction table. The amount depends on the length of the pay period and each employee's wages, marital (or common-law) status, eligible dependants, and other permitted deductions. **Example 13.9** illustrates basic accounting requirements for payroll deductions.

Example 13.9 | Accounting for Payroll Deductions

Facts Assume that Taggar Inc. has a weekly payroll of $10,000 that is entirely subject to CPP (4.95%), EI (1.66%), income tax withholdings of $1,320, and union dues of $88.

Instructions

a. What journal entry would Taggar make to record Salaries and Wages Expense and the related employee payroll deductions?

b. What journal entries would Taggar make for the related employer payroll deductions and the payment to the CRA?

Solution

a. Taggar would make the following entry to record the salaries and wages paid and the employee payroll deductions:

Salaries and Wages Expense	10,000	
Employee Income Tax Deductions Payable		1,320
CPP Contributions Payable		495
EI Premiums Payable		166
Union Dues Payable		88
Cash		7,931

A	=	L	+	SE
−7,931		+2,069		−10,000

Cash flows: ↓ 7,931 outflow

[15] The Quebec rates are somewhat lower than in the rest of Canada because Quebec provides parental benefits separately under a different plan.

b. The required employer payroll taxes are recognized as compensation-related expenses by Taggar in the same accounting period as the payroll is recorded. The entry for the required employer contributions (rounded) is as follows:

Payroll Tax Expense	727	
CPP Contributions Payable ($495 × 1.0)		495
EI Premiums Payable ($166 × 1.4)		232

A	=	L	+	SE
		+727		−727

Cash flows: No effect

Taggar, as the employer, then sends to the Receiver General for Canada the amount of income tax, CPP, and EI deductions withheld from the employees, along with the employer's required contributions for CPP and EI. The entry to record the payment to the CRA for the payroll described above is:

Employee Income Tax Deductions Payable	1,320	
CPP Contributions Payable ($495 + $495)	990	
EI Premiums Payable ($166 + $232)	398	
Cash		2,708

A	=	L	+	SE
−2,708		−2,708		

Cash flows: ↓ 2,708 outflow

Until they are remitted to the government and the union, the amounts owed by Taggar in Example 13.9 are all reported as current liabilities. For a manufacturer, all payroll costs (wages, payroll taxes, and fringe benefits) are allocated to appropriate cost accounts, such as Direct Labour, Indirect Labour, Sales Salaries, or Administrative Salaries.

This somewhat simplified discussion of payroll costs and deductions does not give a clear sense of the large volume of records and clerical work that is needed to maintain a sound and accurate payroll system.

Short-Term Compensated Absences

Compensated absences are periods of time taken off from active employment for which employees are paid, such as statutory holidays and vacation. The entitlement to such benefits is one of two types:

1. accumulating or
2. non-accumulating. See **Underlying Concept 13.3**.

Underlying Concept 13.3

Accounting for obligations for compensated absences is based on liability definition, recognition, and measurement concepts.

Accumulating Rights to Benefits

Law Employers are required under provincial law to give each employee vacation equal to a specified number of days, or to pay them in lieu of the vacation. As a result, employers have an **unconditional obligation** for vacation pay that accrues (or accumulates) as the employees work. This obligation (or liability) is usually satisfied by paying employees their regular salaries when they are absent from work while taking vacation.

Employees may have **vested rights** to some of their benefits that accumulate with service. This means that the employer is legally required to pay the benefits even if the employee no longer works for the organization; thus, vested rights do not depend on an employee's continued service. For example, assume that you have earned 10 days of vacation as at December 31, the end of your employer's fiscal year. Because a minimum level of vacation pay is prescribed by law, your employer will have to pay you for these 10 days even if you resign from your job before taking those days off. In this case, the 10 days of vacation pay is a vested right and the costs are accrued by the company as expense **in the period in which the benefit is earned by the employee**.

Now assume that a company offers its employees an entitlement to vacation days above the legal requirement. Further assume that this entitlement **is not vested**, but that the right to any unused additional vacation can be carried forward to future periods. If you continue to work for the company, you are entitled to the additional unused vacation days, but if you leave the company, you lose the right to them. Although the rights are not vested, they are accumulated rights and the company will have to honour most of those benefits that have been earned. **Accumulated rights**, therefore, are rights that accrue with employee service. They are not necessarily vested but can still be carried forward to future periods if they are not used in the period in which they are earned. In accounting for accumulated rights, the employer recognizes an expense and a liability for the cost of these compensated absences as they are

earned by employees. However, the estimated cost and obligation should reflect that, because of employee turnover, some of these benefits will never be paid.

Entitlement to **sick pay** varies greatly among employers. In some companies, sick pay vests and employees are allowed to accumulate unused sick time. They can take time off from work with pay even though they are not ill, or they will be paid for the unused sick days when they leave the company. In this case, an obligation exists to pay future amounts; therefore, **the liability and expense are accrued** as the employees earn the benefit. We discuss this type of longer-term liability in Chapter 19.

When sick days accumulate with time, but do not vest (that is, they are paid only when an employee is absent due to illness), it may be very difficult to estimate the expense that is associated with the benefits earned by the employees. In estimating the obligation, management takes into account the likelihood that many of the accumulated benefits will never be paid. Usually if the estimate is an immaterial amount, no accrual is made and the entity accounts for such non-vesting sick pay on a pay-as-you-go basis. This means that the expense is recognized in the accounts as the sick days are taken.

What rate should be used to accrue the compensated absence expense and liability: the current rate or an estimated future rate? The **best measure is the additional amount the entity expects to pay in the future** as a result of the benefits accumulated to the reporting date.[16] Many companies use the current rate of pay as the best estimate of the future amount, but other companies use future amounts that are likely to be paid, or that have already been agreed on under collective agreements. **Example 13.10** illustrates vacation pay for Amutron Limited.

Example 13.10 | Accounting for Vacation Pay

Facts To illustrate, assume the following information for Amutron Limited, which began operations on January 1, 2020.

- The company has 10 employees, who are paid $880 per week, and this is the best estimate of the following year's wages as well.
- A total of 20 weeks of vacation is earned by all employees in 2020, but none is taken during the year.
- In 2021, the vacation weeks earned in 2020 are used when the current rate of pay has increased to $900 per week.

Instructions

a. What journal entry would Amutron make to record Salaries and Wages Expense and the related wages payable for its employees' vacation pay?

b. How would these amounts be recorded on Amutron's financial statements?

c. Provide the journal entry for vacation weeks earned in 2020 and used in 2021.

d. Discuss how the difference in the amount accrued and the amount paid is accounted for.

Solution

a. The entry at December 31, 2020, to accrue the vacation pay entitlement earned by the employees is as follows:

Salaries and Wages Expense	17,600	
Vacation Wages Payable ($880 × 20)		17,600

A	=	L	+	SE
		+17,600		−17,600

Cash flows: No effect

b. At December 31, 2020, the company reports a current liability of 20 weeks × $880 or $17,600 on its SFP, and an expense of $17,600 for the benefits earned by employees in 2020.

c. In 2021, the vacation time that is paid for (and that was earned in 2020) is recorded as follows:

Vacation Wages Payable	17,600	
Salaries and Wages Expense	400	
Cash ($900 × 20)		18,000

A	=	L	+	SE
−18,000		−17,600		−400

Cash flows: ↓ 18,000 outflow

[16] Although ASPE does not specifically address this issue, IAS 19.16 *Employee Benefits* specifies that the "expected cost of accumulating paid absences" should be measured as "the additional amount that the entity expects to pay as a result of the unused entitlement that has accumulated at the end of the reporting period." Copyright © IFRS Foundation. All rights reserved. Reproduced with permission.

d. In 2021, the vacation weeks are used and the liability is eliminated. Note that the difference between the cash paid and the reduction in the liability account is recorded as an adjustment to Salaries and Wages Expense in the period when it is paid. This difference occurs because the liability account was accrued at the lower rate of $880 per week. The cash paid, however, is based on the rate of pay in effect when the benefit is taken. If the future pay rates had been estimated accurately and used to calculate the accrual in 2020, then the cash paid in 2021 would have been the same as the liability.

Non-Accumulating Rights to Benefits

Non-accumulating compensated absences, on the other hand, are benefits that employees are entitled to by virtue of their employment and the occurrence of an obligating event. The rights to these benefits do not vest and are accounted for differently than those that accumulate with service. A good example is additional compensation and time off for parental (maternity, paternity, and adoption) leave beyond what the government provides, and some short-term disability benefits. Employees' rights to such benefits do not accrue as they work. The rights accrue only when the requirements of the parental leave or short-term disability plan have been met.[17]

Because the employer has no basis on which to accrue the costs of these benefits and the associated liability, no entry is made until the obligating event occurs. When the parental leave is taken or the employee becomes disabled, the **total** estimated liability and expense associated with the event is recognized at that time. **Example 13.11** illustrates this **event accrual method** of accounting.

Example 13.11 | Accounting for Parental Leave Benefits

Facts Assume that Resource Corp. provides a parental leave benefit plan that promises to pay a qualifying employee, for a period of up to one year, an amount equal to the difference between the employee's current salary and the amount paid by Employment Insurance during the leave. Sue Kim, an employee, applies for and is granted a one-year parental leave to begin on April 18. Resource Corp. calculates that the benefit payable to her will be $200 per week.

Instructions

a. What journal entry would Resource Corp. make to record the employee benefit expense and the related payable for Sue Kim's parental leave at the date that the leave starts?

b. Provide the journal entry to be made for each pay period during the leave. (Assume payroll is done biweekly and disregard other payroll deductions.)

Solution

a. The company makes the following entry when Sue Kim begins her leave on April 18:

Employee Benefit Expense	10,400	
Parental Leave Benefits Payable ($200 × 52 weeks = $10,400)		10,400

A	=	L	+	SE
		+10,400		−10,400

Cash flows: No effect

b. As the compensated absence (the parental leave) is taken and Sue Kim is paid, the liability is reduced. Assuming Resource Corp. has a biweekly payroll, the following entry is made each pay period:

Parental Leave Benefits Payable	400	
Cash		400

A	=	L	+	SE
−400		−400		

Cash flows: ↓ 400 outflow

The compensated absences discussed in this section of the chapter are all relatively short-term in nature. When the associated obligations will be met within 12 months from the date of the SFP, there is no need to discount the future cash outflows when measuring the outstanding liability.[18]

[17] In Canada, statutory parental leave comes under the Employment Insurance program. Many companies, however, offer additional paid parental leave benefits to their employees above the regulated absence from the workplace, usually once they are considered permanent employees.

[18] Longer-term employee benefit obligations associated with compensated absences, including post-employment benefits, are the subject of Chapter 19.

Profit-Sharing and Bonus Agreements

Underlying Concept 13.4

Accounting for bonuses or profit-sharing plans follows underlying concepts. For example, in Japan, traditionally bonuses to members of boards of directors were considered distributions of profits and therefore were charged against retained earnings.

Many companies have a **bonus** or a **profit-sharing** plan for their employees. These plans may be open to all employees or be restricted to those in managerial positions or perhaps only to key company officers. Payments under such plans are in addition to the regular salary or wage and may be a percentage of the employees' regular rates of pay, or they may depend on productivity increases or the amount of the company's annual profit. From the entity's viewpoint, **bonus and profit-sharing payments to employees** are considered additional compensation and are therefore a type of wage or salary expense in determining the net income for the year, as illustrated in **Example 13.12**. Obligations for amounts outstanding are usually reported as current liabilities at the reporting date because they relate to and are based on the results of the period just ended, and are usually payable in the near term. See **Underlying Concept 13.4**.

Example 13.12 | Accounting for a Bonus Plan

Facts Assume that SST Company has income before bonuses of $400,000 for 2020. SST has an annual bonus plan and determines in January 2021 that it will pay out bonuses of $40,700 related to the prior year.

Instructions Prepare the adjusting journal entries that SST should use to account for its bonuses at the time the bonus amount is determined, and at the date of payment in January 2021?

Solution The following entry dated December 31, 2020 is made to record the bonuses:

Bonus Expense	40,700	
Bonus Payable		40,700

In January 2021, when the bonus is paid, the entry is:

Bonus Payable	40,700	
Cash		40,700

A	=	L	+	SE
		+40,700		−40,700

Cash flows: No effect

A	=	L	+	SE
−40,700		−40,700		

Cash flows: ↓ 40,700 outflow

It is important to be careful when calculating bonus and profit-sharing amounts, especially if the formula specifies that the bonus is based on **after-tax** income. Because the additional amount to be paid is itself a tax-deductible expense, simultaneous equations may have to be set up and solved to determine both the expense and tax amounts. Keep in mind that under IFRS, bonus and profit-sharing payments are accrued for constructive obligations where a reasonable estimate of the obligation can be made; that is, where the "entity has no realistic alternative but to make the payments" as a result of past practice (IAS 19.19).

Decommissioning and Restoration Obligations

LEARNING OBJECTIVE 5

Explain the recognition, measurement, and disclosure requirements for decommissioning and restoration obligations.

Law In many industries, the construction and operation of long-lived assets means taking on obligations associated with the eventual retirement of those assets. For example, when a mining company opens up a strip mine, it likely also makes a commitment to restore the land on which the mine is located once the mining activity is completed. Similarly, when an oil company erects an offshore drilling platform, it may be obligated to dismantle and remove the platform at the end of its useful life. Such obligations occur in a variety of ways. For example,

they may arise from acquisition of an asset with an existing asset retirement obligation (such as an oil rig), or they may increase over time through normal operations (such as a mine site that expands over time). Further examples of restorative activities include the following:

1. Decommissioning nuclear facilities
2. Dismantling, restoring, and reclaiming oil and gas properties
3. Closure, reclamation, and removal of mining facilities
4. Closure and post-closure remediation of landfills

In general, the obligation associated with the retirement of a long-lived asset that results from acquiring, constructing, developing, or operating it must be recognized by the company **in the period when the obligation is incurred**.[19] This liability is known as an **asset retirement obligation (ARO)** or **site restoration obligation**.

While this general principle underlies both the IFRS and ASPE standards, there is a difference in the type of obligation that is recognized and which activities' costs are capitalized as part of the capital asset's cost. A table indicating the differences was presented in Chapter 10, and it is summarized here as **Illustration 13.2**.

ILLUSTRATION 13.2
Law Asset Retirement Costs: IFRS versus ASPE

	IFRS	ASPE
Category of obligations	Recognizes costs of **both legal** and **constructive obligations**, such as when an entity creates an expectation in others, through its own actions, that it will meet this obligation.	Recognizes costs associated with **legal obligations** only.
Category of activities	Costs included as capital assets are only those related to the acquisition of the asset, not those related to the subsequent production of goods or services (product costs).	Costs included as capital assets are both ARO-related costs resulting from the acquisition of the asset and its subsequent use in producing inventory, such as oil.

The first difference relates to the fact that IFRS recognizes a broader group of non-financial obligations as liabilities: both legal and constructive obligations. The position on the second difference is consistent with the concept that costs incurred in the production of goods and services are inventory or product costs. ASPE recognizes all such costs as part of the capital asset. Because the costs capitalized to property, plant, and equipment under ASPE are often amortized subsequently as product costs, this GAAP difference may not have a significant effect on financial results.

Measurement

The liability is initially measured at "the best estimate of the expenditure required to settle the present obligation" at the reporting date.[20] Under the recently released conceptual framework for financial reporting, a liability is defined as a present obligation to transfer an economic resource as a result of past events. Because the obligation will often be met many years in the future, discounting the future costs is one requirement in determining the present amount required. Significant application guidance is provided on how this measurement should be approached.

[19]ASPE recognizes this type of liability only when a reasonable estimate can be made of the amount.

[20]IAS 37.36 (*Provisions, Contingent Liabilities and Contingent Assets*). Copyright © IFRS Foundation. All rights reserved. Reproduced with permission. Reprinted/adapted with permission from the CPA Canada Handbook—Accounting © 2018, Part II, Section 3110.09 (*Asset Retirement Obligations*), by Chartered Professional Accountants of Canada. All rights reserved by the copyright owner.