Chapter 10

Current liabilities

REAL WORLD CASE

19 Creditors: Amounts falling due within one year

	Group		Company	
	2005	Restated 2004	**2005**	2004
	£'000	£'000	**£'000**	£'000
Loans and overdrafts	**71,994**	16,274	**67,499**	15,000
Trade creditors	**254,768**	181,780	**–**	–
Amounts owed to subsidiary undertakings	**–**	–	**353,007**	314,152
Corporation tax	**37,556**	30,106	**–**	–
Other taxes and social security costs	**33,612**	26,668	**–**	–
Other creditors	**44,648**	38,988	**11,296**	1,230
Accruals and deferred income	**120,893**	106,546	**4,784**	6,293
Proposed dividends	**10,968**	7,869	**10,968**	7,869
	574,439	408,231	**447,554**	344,544

Prior year accruals and deferred income have been restated to reflect the reallocation of unearned insurance income of £8.1m which had previously been included in provisions for liabilities and charges (see note 22).

Supplier payment policy

The Group's policy is to agree terms of transactions, including payment terms, with suppliers and, provided that suppliers perform in accordance with the agreed terms, it is the Group's normal practice that payment is made accordingly. The number of days outstanding between receipt of invoices and date of payment, calculated by reference to the amount owed to trade creditors at the period end as a proportion of the amounts invoiced by suppliers during the period, was 47 days (2004 – 42 days). The Company did not have any trade creditors at 2 April 2005 or 27 March 2004.

Source: The Carphone Warehouse Group plc, Annual Report 2005, pp. 49, 32.

Discussion points

1 What do we learn about the group's policy of paying suppliers?

2 How significant is the amount of trade creditors in the current liabilities?

Contents

Learning outcomes

After studying this chapter you should be able to:

- Define a liability and explain the distinguishing feature of current liabilities.
- Explain the conditions for recognition of liabilities.
- Explain how the information presented in a company's balance sheet and notes, in relation to liabilities, meets the needs of users.
- Explain the features of current liabilities and the approach to measurement and recording.
- Explain the terms 'accruals' and 'matching concept' and show how they are applied to expenses of the period.
- Explain how liabilities for taxation arise in companies.

Additionally, for those who choose to study the Supplement:

- Prepare the ledger accounts to record accruals.

10.1 Introduction

The theme running through this textbook is the accounting equation:

Assets	minus	**Liabilities**	equals	**Ownership interest**

It was explained in Chapter 2 that the ownership interest is the residual amount found by deducting all liabilities of the company from total assets. Chapters 8 and 9 have taken you through aspects of non-current and current assets which are particularly significant to users of financial statements. Chapters 10 and 11 complete the left-hand side of the equation by providing a similar overview of current liabilities and non-current liabilities.

This chapter follows the approach established in Chapters 8 and 9:

- What are the principles for defining and recognising these items?
- What are the information needs of users in respect of the particular items?
- What information is currently provided by companies to meet these needs?
- Does the information show the desirable qualitative characteristics of financial statements?
- What are the principles for measuring, and processes for recording, these items?

10.2 Definitions

The definition of a liability, as provided in Chapter 2, is repeated here:

Definition

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]

A **current liability** is a liability which satisfies any of the following criteria:

(a) it is expected to be settled in the entity's normal operating cycle;
(b) it is held primarily for the purpose of being traded;
(c) it is due to be settled within twelve months after the balance sheet date.[2]

Supplement 7.1 to Chapter 7 sets out the information to be presented on the face of the balance sheet of companies using the IASB system in their financial statements. The only current liabilities listed there are item (j) trade and other payables, item (l) financial liabilities (where these are short-term loans) and (m) liabilities for current tax.

Supplement 7.2 to Chapter 7 sets out the information to be presented in the financial statements of companies that are using the UK Companies Act and UK ASB standards. There is one heading for current liabilities and a detailed list below. The list is as follows:

E Creditors: amounts falling due within one year
1 Debenture loans
2 Bank loans and overdrafts
3 Payments received on account
4 Trade creditors
5 Bills of exchange payable
6 Amounts owed to group undertakings
7 Amounts owed to undertakings in which the company has a participating interest
8 Other creditors including taxation and social security
9 Accruals and deferred income

Activity 10.1

Look back to Exhibit 2.3, which analyses some common types of liability. Set up on a blank sheet a similar table with four columns and headings for: type of liability; obligation; transfer of economic benefits; and past transaction or event. Then close the book and write down any ten liabilities you have come across during your study. Fill in all the columns as a check that, at this stage, you really understand what creates a liability.

10.3 Recognition

The general conditions for recognition were set out in Chapter 2. An item that meets the definition of a liability should be recognised if there is sufficient evidence that the liability has been created and that the item has a cost or value that can be measured with sufficient reliability. In practice, recognition problems related to liabilities centre on ensuring that none is omitted which ought to be included. This is in contrast to the case of assets where there is a need, in practice, to guard against over-enthusiastic inclusion of items which do not meet the recognition conditions.

10.3.1 Risk of understatement of liabilities

The risk related to liabilities is therefore the risk of understatement. This is explained in Chapter 4 under the heading of prudence. The risk of understatement of liabilities is that it will result in overstatement of the ownership interest.

In recent years the standard-setting bodies have devoted quite strenuous efforts to discouraging companies from keeping liabilities (and related assets) off the balance sheet. This problem is called **off-balance sheet finance** and will be explained in Chapter 14.

10.3.2 Non-recognition: contingent liabilities

There are some obligations of the company which fail the recognition test because there is significant uncertainty about future events that may cause benefits to flow from the company. The uncertainty may be about the occurrence of the event or about the measurement of the consequences. These are called **contingent liabilities** because they are contingent upon (depend upon) some future event happening. Examples are:

- A company is involved in legal action where a customer is seeking damages for illness allegedly caused by the company's product. If the customer is successful, there will be more claims. The company does not believe that the customer will succeed.
- A parent company has given guarantees to a bank that it will meet the overdraft and loans of a subsidiary company if that company defaults on repayment. At the present time there is no reason to suppose that any default will take place.
- A company is under investigation by the Competition Commission for possible price-fixing within the industry in contravention of an order prohibiting restrictive practices. If there is found to be a restrictive practice, a penalty may be imposed.
- The company has acquired a subsidiary in Australia where the tax authorities have raised an action for tax due on a disputed transaction which occurred before the subsidiary was acquired. The action is being defended strenuously.

In each of these examples, the company is convinced that it will not have a liability at the end of the day, but the users of the financial statements may wish to have some indication of the upper bounds of the liability if the company's optimism proves unfounded. There may, however, be a problem for the company in publishing an estimate of the amount of the possible liability because it may be seen as admitting liability and furthermore may require disclosure of commercially sensitive confidential information.

Where a **contingent liability** is identified, the obligation is not recognised in the balance sheet but it may be important that users of the financial statements are aware of the problem. There will therefore be a note to the balance sheet reporting the circumstances of the contingent liability and sometimes giving an indication of the amount involved. Because of the confidentiality aspect, companies tend to give little information about the financial effect of a contingent liability, but some will try to set the outer limits of the liability.

Definition

A **contingent liability** is:

either:

(a) a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence of one or more uncertain future events not wholly within the control of the entity; or
(b) a present obligation that arises from past events but is not recognised because:
  (i) either it is not probable that a transfer of economic benefits will be required to settle the obligation;
  (ii) or the amount of the obligation cannot be measured with sufficient reliability.[3]

A company should disclose a brief description of the nature of the contingent liability and, where practicable:

(a) an estimate of its financial effect;
(b) an indication of the uncertainties relating to the amount or timing of any outflow; and
(c) the possibility of any reimbursement.[4]

Rules about measurement are given in detail in the accounting standard. The detail is not necessary for an introductory course.

10.3.3 Changing thoughts on contingencies

In 2005 the IASB issued a proposal to eliminate the term 'contingent liability' because if the item cannot be recognised in a balance sheet then it cannot be a true liability. The proposal of the IASB was that items carrying an unconditional obligation should be recognised as a liability and measured at the best estimate. Any uncertain event affecting the measurement of the obligation would be explained in a note. Items that do not carry an unconditional obligation are seen as business risks. Such business risks would be reported as a note to the financial statements because they may have a significant effect on the carrying amount of assets and liabilities in the near future. These changing thoughts on contingencies do not change the overall amount of information to be disclosed about contingencies but the method of disclosure may change.

Activity 10.2

Consider the four examples of contingent liability given at the start of this section. Based on the definition, explain why each is a contingent liability.

10.4 Users' needs for information

There are two aspects of information in relation to liabilities. The first relates to the amount owed (sometimes called the **principal sum** or the **capital amount**) and the second relates to the cost of servicing the loan (usually the payment of **interest**).

In respect of current liabilities, other than a bank overdraft or bank loans repayable within the year, it is unlikely that interest will be payable, and so generally there will be no information about interest charges. The shareholders in the company will be concerned that there are adequate current assets to meet the current liabilities as they fall due. Those who supply goods and services will want to be reassured that payment will be made on the due date.

Owners of a company need to know how much the company owes to other parties because the owners are at the end of the queue when it comes to sharing out the assets of the company if it closes down. Many of those who supply goods and services are what is known as unsecured creditors, which means they come at the end of the list of creditors. They will also have an interest in the balance of long-term and current liabilities.

10.5 Information provided in the financial statements

The balance sheet of Safe and Sure plc, set out in Chapter 7, contains the following information in relation to current liabilities:

	Notes	Year 7 £m	*Year 6 £m*
Current liabilities			
Amounts payable (creditors)	*7*	(159.8)	*(157.5)*
Bank overdraft	*8*	(40.1)	*(62.6)*
		(199.9)	*(220.1)*

Notes to the balance sheet explain more about the balance sheet items. Note 7 lists the details of current liabilities.

Note 7 Current liabilities: amounts payable

	Year 7 £m	*Year 6 £m*
Deferred consideration on acquisition	1.1	*4.3*
Trade payables (trade creditors)	23.6	*20.4*
Corporation tax	31.5	*26.5*
Other tax and social security payable	24.5	*21.2*
Other payables (creditors)	30.7	*23.8*
Accruals and deferred income	48.4	*61.3*
	159.8	157.5

Note 8 gives information on bank overdrafts due on demand and confirms that the interest charges incurred on these loans are payable at commercial rates:

Note 8 Bank borrowings: current liabilities

	Year 7 £m	*Year 6 £m*
Bank overdrafts due on demand:	40.1	*62.6*

Interest on overdrafts is payable at normal commercial rates appropriate to the country where the borrowing is made.

The report of the finance director provides further insight into the currency spread of the bank borrowings:

> *Foreign currency: £35.2m of foreign currency bank borrowings have been incurred to fund overseas acquisition. The main borrowings were £26.8m in US dollars and £8.4m in Japanese yen. The borrowings are mainly from banks on a short-term basis, with a maturity of up to one year, and we have fixed the interest rate on $20m of the US dollar loans through to November, Year 7, at an overall cost of 4.46%.*

All material foreign currency transactions are matched back into the currency of the group company undertaking the transaction.

David Wilson has already commented in Chapters 4 and 7 on some aspects of the liabilities in the financial statements of Safe and Sure plc. Here he is explaining to Leona, in the coffee bar at the health club, his views on current liabilities in particular.

DAVID: *Current liabilities are relatively similar in total to last year so there are no particular questions to ask there.*

Then I start to think about the limits of risk. There is £40m due for repayment to the bank within the year. Will the company have any problem finding this amount? With £105m in cash and cash, it seems unlikely that there could be a problem. The entire current liabilities are £199.9m, all of which could be met from the cash and cash equivalents and receivables (debtors).

There is another risk that £40m shown as owing to the banks may be the wrong measure of the liability if exchange rates move against the company. Whenever I see foreign borrowings I want to know more about the currency of borrowings. You know from your economics class the theory of interest rates and currency exchange rates. It backs up my rule of thumb that borrowing in currencies which are weak means paying high rates of interest. Borrowing in currencies which are strong will mean paying lower rates of interest but runs a greater risk of having to use up additional pounds sterling to repay the loan if the foreign currency strengthens more. Information about the currency mix of loans is something I can probably get from the company if I need it. In this case, the finance director's report is sufficiently informative for my purposes. In past years, before finance directors started providing explanations in the annual report, we were asking these questions at face-to-face meetings.

LEONA: *What you have described is similar in many respects to the analytical review carried out by the auditors. We do much more than merely check the bookkeeping entries and the paperwork. We are looking at whether the balance sheet makes sense and whether any items have changed without sufficient explanation.*

10.6 Measurement and recording

Liabilities are measured at the amount originally received from the lender of finance or supplier of goods and services, plus any additional charges incurred such as rolled-up interest added to a loan. This is generally agreed to be a useful measure of the obligation to transfer economic benefits from the company.

From the accounting equation it may be seen that an increase in a liability must be related either to an increase in an asset or a decrease in the ownership interest. Usually any related decrease in the ownership interest will be reported in the balance sheet as an expense.

The most significant current liabilities for most companies are bank borrowing and trade creditors. Both of these are essential sources of finance for small companies and are an important aspect, if not essential, for larger companies.

Activity 10.3

Write down the documentation you would expect to see as evidence of the money amount of the following liabilities:

- *bank overdraft;*
- *amount owing to a trade supplier.*

Now read the next sections and find whether your answer matches the information in the text.

10.6.1 Bank overdraft finance

Banks provide short-term finance to companies in the form of an overdraft on a current account. The advantage of an overdraft is its flexibility. When the cash needs of the company increase with seasonal factors, the company can continue to write cheques and watch the overdraft increase. When the goods and services are sold and cash begins to flow in, the company should be able to watch the overdraft decrease again. The most obvious example of a business which operates in this pattern is farming. The farmer uses the overdraft to finance the acquisition of seed for arable farming, or feed through the winter for stock farming and to cover the period when the crops or animals are growing and maturing. The overdraft is reduced when the crops or the animals are sold.

The main disadvantage of an overdraft is that it is repayable on demand. The farmer whose crop fails because of bad weather knows the problem of being unable to repay the overdraft. Having overdraft financing increases the worries of those who manage the company. The other disadvantage is that the interest payable on overdrafts is variable. When interest rates increase, the cost of the overdraft increases. Furthermore, for small companies there are often complaints that the rate of interest charged is high compared with that available to larger companies. The banks answer that the rates charged reflect relative risk and it is their experience that small companies are more risky.

10.6.2 Trade payables (trade creditors)

It is a strong feature of many industries that one enterprise is willing to supply goods to another in advance of being paid. Most suppliers will state terms of payment (e.g. the invoice must be paid within 30 days) and some will offer a discount for prompt payment. In the UK it has not been traditional to charge interest on overdue accounts but this practice is growing as suppliers realise there is a high cost to themselves of not collecting cash in good time. A supplier who is waiting to be paid is called a **trade creditor**.

Trade creditors rarely have any security for payment of the amount due to them, so that if a customer fails to pay the supplier must wait in the queue with other suppliers and hope for a share of some distribution. They are described as **unsecured creditors**. Some suppliers will include in the contract a condition that the goods remain the property of the supplier should the customer fail to pay. This is called retention of title (ROT) and will be noted in the balance sheet of a company which has bought goods on these terms. Retention of title may offer some protection to the unpaid supplier but requires very prompt action to recover identifiable goods in the event of difficulty.

Some suppliers send goods to a customer on a sale-or-return basis. If there are no conditions to prevent return then the goods will not appear as stock in the balance sheet of the customer and there will be no indication of a liability. This practice is particularly common in the motor industry where manufacturers send cars to showrooms for sale or return within a specified period of time. Omitting the inventories and the related potential liability is referred to as **off-balance sheet finance**, a topic explored further in Chapter 14.

Suppliers send **invoices** to the customer showing the amount due for payment. These invoices are used in the customer's accounts department as the source of information for liabilities. At the end of the month the suppliers send statements as a reminder of unpaid invoices. Statements are useful as additional evidence of liabilities to suppliers.

Measurement of trade creditors is relatively straightforward because the company will know how much it owes to short-term creditors. If it forgets the creditors, they will soon issue a reminder.

Recording requires some care because omission of any credit transaction will mean there is an understatement of a liability. In particular, the company has to take some care at the end of the year over what are called **cut-off procedures**. Take the example of raw materials provided by a supplier. The goods arrive at the company's store by delivery van but the invoice for their payment arrives a few days later by mail. The accounts department uses the supplier's invoice as the document which initiates the *recording* of the asset of stock and the liability to the supplier. In contrast, the event which *creates* the liability is the acceptance of the goods. (It is difficult for the accounts department to use the delivery note as a record of the liability because it shows the quantities but not the price of the goods delivered.) So, at the end of the accounting year the accounts department has to compare the most recent delivery notes signed by the storekeeper with the most recent invoices received from the supplier. If goods have been received by the company, the balance sheet must include the asset of stock and the related liability. Using a similar line of reasoning, if a supplier has sent an invoice ahead of delivery of the goods, it should not be recorded as a liability because there is no related asset.

The recording of purchases of goods for resale is shown in Chapter 6. In the illustration of the process for recording the transactions of M. Carter there is a purchase of goods from the supplier, R. Busby, on credit terms. Payment is made later in the month. The purchase of the goods creates the asset of stock and the liability to the supplier. Payment to the supplier reduces the asset of cash and eliminates the liability to the supplier.

10.7 Accruals and the matching concept

At the balance sheet date there will be obligations of the company to pay for goods or services which are not contained in the accounting records because no document has been received from the supplier of the goods or services. It is essential that all obligations are included at the balance sheet date because these obligations fall under the definition of liabilities even although the demand for payment has not been received. The process of including in the balance sheet all obligations at the end of the period is called the accrual of liabilities and is said to reflect the **accruals** basis or accruals concept (see Chapter 4).

Definition

Under the **accruals basis**, the effects of transactions and other events are recognised when they occur (and not as cash or its equivalent is received or paid) and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate.[5]

The argument contained in the previous paragraph is based on the definition of a liability, but some people prefer to arrive at the same conclusion using a different argument. They say that all expenses of the accounting period must be matched against the revenue earned in the period. If a benefit has been consumed, the effect must be recorded whether or not documentation has been received. This argument is referred to as the **matching concept**.

In the *Framework*, the IASB explains that in the income statement there is a direct association between the costs incurred and the earning of specific items of income. This process is called the matching of costs with revenues. As an example, the expenses that make up the cost of goods sold are recognised at the same time as the revenue derived from the sale of the goods.[6]

The accruals concept and the matching concept are, for most practical purposes, different ways of arriving at the same conclusion. (There are exceptions but these are well beyond the scope of a first-level text.)

10.7.1 The distinction between the expense of the period and the cash paid

A company starts business on 1 January Year 1. It has a financial year-end of 31 December Year 1. During Year 1 it receives four accounts for electricity, all of which are paid ten days after receiving them. The dates of receiving and paying the accounts are as follows:

Date invoice received	*Amount of invoice*	*Date paid*
	£	
31 Mar. Year 1	350	10 Apr. Year 1
30 June Year 1	180	10 July Year 1
30 Sept. Year 1	280	10 Oct. Year 1
31 Dec. Year 1	340	10 Jan. Year 2
	1,150	

The company has used electricity for the entire year and therefore should match against revenue the full cost of £1,150. Only three invoices have been paid during the year, the final invoice not being paid until the start of Year 2. That is important for cash flow but is not relevant for the measurement of profit. The transactions during the year would be recorded as shown in Exhibit 10.1. The arrival of the electricity invoice causes a record to be made of the increase in the liability and the increase in the expense (decreasing the ownership interest). The payment of the amount due requires a separate record to be made of the decrease in the liability and the decrease in the asset of cash.

Exhibit 10.1
Spreadsheet analysis of transactions relating to the expense of electricity consumed, Year 1

Date	*Transactions with electricity company*	*Asset*	*Liability*	*Ownership interest:profit of the period*
		Cash	*Electricity company*	*Electricity expense*
Year 1		£	£	£
Mar. 31	Invoice received £350		350	(350)
Apr. 10	Pay electricity company £350	(350)	(350)	
June 30	Invoice received £180		180	(180)
July 10	Pay electricity company £180	(180)	(180)	
Sept. 30	Invoice received £280		280	(280)
Oct. 10	Pay electricity company £280	(280)	(280)	
Dec. 31	Invoice received £340		340	(340)
	Totals	(810)	340	(1,150)

The payment made to the electricity company in January Year 2 is not recorded in Exhibit 10.1 because it is not a transaction of Year 1. It will appear in a spreadsheet for January Year 2. The totals at the foot of the spreadsheet show that the transactions of Year 1 have caused the cash of the company to decrease by £810. There remains a liability of £340 to the electricity company at the end of Year 1. The profit and loss account for the year will show an expense of £1,150. The spreadsheet satisfies the accounting equation because there is a decrease in an asset, amounting to £810, and an increase in a liability amounting to £340. These together equal the decrease of £1,150 in the ownership interest:

Asset ↓	−	Liability ↑	=	Ownership interest ↓
− £810		+ £340		− £1,150

That one needs a little careful thought because several things are happening at once. You might prefer to think about it one stage at a time. You know from earlier examples in Chapters 2, 5 and 6 that a decrease in an asset causes a decrease in the ownership interest. You also know that an increase in a liability causes a decrease in the ownership interest. Put them together and they are both working in the same direction to decrease the ownership interest.

10.7.2 Accrual where no invoice has been received

Now consider what might happen if the final electricity invoice for the year has not been received on 31 December Year 1. If no invoice has been received then there will be no entry in the accounting records. That, however, would fail to acknowledge that the electricity has been consumed and the company knows there is an obligation to pay for that electricity. In terms of the matching concept, only nine months' invoices are available to match against revenue when there has been 12 months' usage. The answer is that the company must make an *estimate* of the accrual of the liability for electricity consumed. Estimates will seldom give the true answer but they can be made reasonably close if some care is taken. If the company keeps a note of electricity meter readings and knows the unit charge, it can calculate what the account would have been.

The entries in the spreadsheet at the end of the month are shown in Exhibit 10.2. They will be the same numerically as those in the final line of Exhibit 10.1 but the item shown at 31 December will be described as an accrual.

Exhibit 10.2
Spreadsheet entry for accrual at the end of the month

Date	*Transactions with electricity company*	*Asset*	*Liability*	*Ownership interest:profit of the period*
		Cash	*Electricity company*	*Electricity expense*
Year 1		£	£	£
Dec. 31	Accrual for three months		340	(340)

10.7.3 The nature of estimates in accounting

Making an accrual for a known obligation, where no invoice has been received, requires estimates. In the example given here it was a relatively straightforward matter to take a meter reading and calculate the expected liability. There will be other examples where the existence and amount of an expense are both known with reasonable certainty. There will be some cases where the amount has to be estimated and the estimate is later found to be incorrect. That is a normal feature of accounting, although not all users of financial statements realise there is an element of uncertainty about the information provided. If a liability is unintentionally understated at the end of a period, the profit will be overstated. In the next accounting period, when the full obligation becomes known, the expense incurred will be higher than was anticipated and the profit of that period will be lower than it should ideally be. If the error in the estimate is found to be such that it would change the views of the main users of financial statements, a prior year adjustment may be made by recalculating the profits of previous years and reporting the effect, but that is a relatively rare occurrence.

Activity 10.4

Write down five types of transaction where you might expect to see an accrual of expense at the year-end. Against each transaction type write down the method you would use to estimate the amount of the accrued expense.

10.8 Liabilities for taxation

In the balance sheet of a company there are two main categories of liability related directly to the company. The first is the **corporation tax** payable, based on the taxable profits of the period, the second is **deferred taxation**. Each of these will be discussed here. You will also see in the current liabilities section of a balance sheet the words ‘other tax and social security payable’. This refers to the amounts deducted from employees’ salaries and wages by the company on behalf of the Inland Revenue and paid over at regular intervals. In respect of such amounts the company is acting as a tax collecting agent of the Inland Revenue.

10.8.1 Corporation tax

Companies pay corporation tax based on the taxable profit of the accounting period (usually one year). The taxable profit is calculated according to the rules of tax law. That in itself is a subject for an entire textbook but one basic principle is that the taxable profit is based on profit calculated according to commercially accepted accounting practices. So, apart from some specific points of difference, the accounting profit is usually quite close to the taxable profit. Assume that the corporation tax rate is 30% of the taxable profit. (The tax rate each year is set by the Chancellor of the Exchequer.) Analysts will evaluate the tax charge in the profit and loss account as a percentage of taxable profit and start to ask questions when the answer is very different from 30%. The explanation could be that there are profits earned abroad where the tax rate is different, but it could also be that there has been some use of provisions or adjustments for accounting purposes which are not allowed for tax purposes. That will lead to more probing by the analysts to establish whether they share the doubts of the tax authorities.

Large companies must pay corporation tax by four quarterly instalments. A company with a year-end of 31 December Year 1 will pay on 14 July Year 1, 14 October Year 1, 14 January Year 2 and 14 April Year 2. The amount of tax due is estimated by making a forecast of the profit for the year. As the year progresses the forecast is revised and the tax calculation is also revised. This means that at the end of the accounting year there is a liability for half that year’s tax bill. A ‘large’ company is any company that pays corporation tax at the full rate. Small companies, which have a special, lower, rate of corporation tax, pay their tax bill nine months after the end of the accounting period. The precise limits for defining ‘large’ and ‘small’ companies change with tax legislation each year. (You will be given the necessary information in any exercise that you are asked to attempt.) Suppose the taxable profit is £10m and the tax payable at 30% is £3m. During the year £1.5m is paid in total on the first two instalment dates. At the balance sheet date there will remain a liability of £1.5m to be paid in total on the final two instalment dates.

	Assets	–	Liabilities	=	Ownership interest
During year	↓ £1.5m Cash				↓ £1.5m (Tax expense)
At end of year			↓ £1.5m Tax liability		↓ £1.5m (Tax expense)

10.8.2 Deferred taxation liability

It was explained earlier in this section that the taxable profit is based on the accounting profit unless there are taxation rules which indicate otherwise. There are taxation rules which allow companies to defer the payment of some taxation on the full accounting profit. ('Deferring' means paying much later than the normal period of nine months.) The deferral period might be for a few months or it might be for a few years. The obligation to pay tax eventually cannot be escaped but the liability becomes long term. This is reflected, in terms of the accounting equation, by reporting the decrease in ownership claim in the profit and loss account but showing the deferred liability as a separate item under **non-current liabilities**.

10.9 Summary

- A **current liability** is a liability which satisfies any of the following criteria:
  (a) it is expected to be settled in the entity's normal operating cycle;
  (b) it is held primarily for the purpose of being traded;
  (c) it is due to be settled within twelve months after the balance sheet date.
- The risk of understatement of liabilities is that it will result in overstatement of the ownership interest.
- **Off-balance sheet finance** means keeping liabilities (and related assets) off the balance sheet.
- There are some obligations of the company which fail the recognition test because there is significant uncertainty about future events that may cause benefits to flow from the company. These are reported as **contingent liabilities** in the notes to the financial statements.
- Users need to know about the existence of liabilities, the amount and timing of expected repayments, and interest charges payable on loans.
- Under the **accruals** basis, the effects of transactions and other events are recognised when they occur (and not as cash or its equivalent is received or paid) and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate.
- Liabilities for unpaid expenses are often called **accruals**.
- The **matching concept** is the idea that all expenses of the accounting period must be matched against the revenue earned in the period. If a benefit has been consumed, the effect must be recorded whether or not documentation has been received.
- Companies pay corporation tax. The arrangements vary depending on the size of the company but there will usually be a liability for unpaid corporation tax in the current liabilities section of the balance sheet. Where government policy allows payment to be delayed for more than 12 months the liability is described as **deferred taxation**.

QUESTIONS

The Questions section of each chapter has three types of question. 'Test your understanding' questions to help you review your reading are in the 'A' series of questions. You will find the answers to these by reading and thinking about the material in the book. 'Application' questions to test your ability to apply technical skills are in the 'B' series of questions. Questions requiring you to show skills in problem solving and evaluation are in the 'C' series of questions. A letter [S] indicates that there is a solution at the end of the book.

A Test your understanding

A10.1 What is the definition of a liability? (Section 10.2)

A10.2 What is the distinction between a long-term liability and a current liability? (Section 10.2)

A10.3 What is the effect of understatement of liabilities? (Section 10.3.1)

A10.4 What is a contingent liability? (Section 10.3.2)

A10.5 What information do users of financial statements need to have concerning current liabilities of a company? (Section 10.4)

A10.6 How are the current liabilities for (a) bank overdraft and (b) trade creditors measured? (Section 10.6)

A10.7 What is meant by an accrual? How is it recorded? (Section 10.7)

A10.8 Explain what is meant by the matching concept. (Section 10.7)

A10.9 [S] On reviewing the financial statements, the company accountant discovers that a supplier's invoice for an amount of £10,000 has been omitted from the accounting records. The goods to which the invoice relates are held in the warehouse and are included in stock. What will be the effect on the profit and loss account and the balance sheet when this error is rectified?

A10.10 [S] On reviewing the financial statements, the company accountant discovers that a payment of £21,000 made to a supplier has been omitted from the cash book and other internal accounting records. What will be the effect on the profit and loss account and the balance sheet when this omission is rectified?

A10.11 [S] On reviewing the financial statements, the company accountant discovers that an invoice for the rent of £4,000 owed to its landlord has been recorded incorrectly as rent receivable of £4,000 in the company's accounting records. What will be the effect on the profit and loss account and the balance sheet when this error is rectified?

B Application

B10.1 [S]
White Ltd commenced trading on 1 July Year 3 and draws up its accounts for the year ended 30 June Year 4. During its first year of trading the company pays total telephone expenses of £3,500. The three-month bill paid in May Year 4 includes calls of £800 for the quarter up to 30 April Year 4 and advance rental of £660 to 31 July Year 4. The bill received in August Year 4 includes calls of £900 for the quarter up to 31 July Year 4 and advance rental of £660 to 31 October Year 4.

Required
Show calculations of the telephone expense to be recorded in the profit and loss account of White Ltd for its first year of trading.

B10.2 [S]

Plastics Ltd pays rent for a warehouse used for storage. The quarterly charge for security guard services is £800. The security firm sends an invoice on 31 March, 30 June, 30 September and 31 December. Plastics Ltd always pays the rent five days after the invoice is received. The security services have been used for some years. Plastics Ltd has an accounting year-end of 31 December.

Required

Prepare a spreadsheet to show how the transactions of one year in respect of security services are recorded.

B10.3 [S]

The accountant of Brown Ltd has calculated that the company should report in its profit and loss account a tax charge of £8,000 based on the taxable profit of the period. Of this amount, £6,000 will be payable nine months after the accounting year-end but £2,000 may be deferred for payment in a period estimated at between three and five years after the accounting year-end. Using the accounting equation explain how this information will be reported in the financial statements of Brown Ltd.

C Problem solving and evaluation

C10.1 [S]

The following file of papers was found in a cupboard of the general office of Green Ltd at the end of the accounting year. Explain how each would be treated in the financial statements and state the total amount to be reported as an accrued liability on the balance sheet date. The year-end is 31 December Year 1.

Item	*Description*	*Amount* £
1	Invoice dated 23 December for goods received 21 December.	260
2	Invoice dated 23 December for goods to be delivered on 3 January Year 2.	310
3	Foreman's note of electricity consumption for month of December – no invoice yet received from electricity supply company.	100
4	Letter from employee claiming overtime payment for work on 1 December and note from personnel office denying entitlement to payment.	58
5	Telephone bill dated 26 December showing calls for October to December.	290
6	Telephone bill dated 26 December showing rent due in advance for period January to March Year 2.	90
7	Note of payment due to cleaners for final week of December (to be paid on 3 January under usual pattern of payment one week in arrears).	48
8	Invoice from supplier for promotional calendars received 1 December (only one-third have yet been sent to customers).	300
9	Letter dated 21 December Year 1 to customer promising a cheque to reimburse damage caused by faulty product – cheque to be sent on 4 January Year 2.	280
10	Letter dated 23 December promising donation to local charity – amount not yet paid.	60

Activities for study groups

Turn to the annual report of a listed company which you have used for activities in previous chapters. Find every item of information about current liabilities. (Start with the financial statements and notes but look also at the operating and financial review, chief executive's review and other non-regulated information about the company.)

Divide into two groups. One group should take on the role of the purchasing director and one should take on the role of a company which has been asked to supply goods or services to this company on credit terms.

- *Supplier group*: What questions would you ask to supplement what you have learned from the annual report?
- *Purchasing director*: What questions would you ask about the supplier? What might you learn about the supplier from the annual report of the supplier's company?

Notes and references

1. IASB (1989) *Framework*, para. 49(b).
2. IASB (2004) IAS 1, para. 60.
3. IASB (2004) IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, para. 10.
4. *Ibid*., para. 86.
5. IASB (1989) *Framework*, para. 23.
6. IASB (1989) *Framework*, para. 95.

Supplement to Chapter 10

Bookkeeping entries for accruals

In the main part of the chapter the accruals for electricity were analysed. Now consider the debit and credit recording. The following transactions are to be recorded.

A company starts business on 1 January Year 1. It has a financial year-end of 31 December Year 1. During Year 1 it receives three accounts for electricity, all of which are paid ten days after receiving them. The dates of receiving and paying the accounts are as follows:

Amount of invoice £	*Date invoice received*	*Date paid*
350	31 Mar. Year 1	10 Apr. Year 1
180	30 June Year 1	10 July Year 1
280	30 Sept. Year 1	10 Oct. Year 1

At 31 December the final invoice for the year has not arrived because of delays in the mail but the amount due for payment is estimated at £340.

Activity 10.5

Before you read further, attempt to write down the debit and credit entries for: each of the three invoices received; the payments of those three invoices; and the estimated amount due for payment at the end of the year. You may find help in looking back to Exhibits 10.1 and 10.2.

Exhibit 10.3 sets out the debit and credit aspect of each transaction and event. The amount of the liability to the supplier cannot be recorded until the invoice is received. The credit entry for the estimate of the amount owing to the supplier is therefore shown in a separate account called *accruals* which will be the basis for the amount shown in the balance sheet under that heading.

The ledger accounts required here are:

L1 Expense (electricity)
L2 Liability to supplier
L3 Accrual

Also required to complete the double entry, but not shown here as a ledger account, are:

L4 Cash
L5 Profit and loss account

Exhibit 10.3
Analysis of debit and credit aspect of each transaction and event

Date	*Transaction*	*Debit*	*Credit*
Year 1			
Mar. 31	Receive invoice for electricity £350	Expense (electricity)	Liability to supplier
Apr. 10	Pay supplier £350	Liability to supplier	Cash
June 30	Receive invoice for electricity £180	Expense (electricity)	Liability to supplier
July 10	Pay supplier £180	Liability to supplier	Cash
Sept. 30	Receive invoice for electricity £280	Expense (electricity)	Liability to supplier
Oct. 10	Pay supplier £280	Liability to supplier	Cash
Dec. 31	Estimate amount owing to supplier £340	Expense (electricity)	Accruals

L1 Expense (Electricity)

Date	*Particulars*	*Page*	*Debit*	*Credit*	*Balance*
Year 1			£	£	£
Mar. 31	Invoice from supplier	L2	350		350
June 30	Invoice from supplier	L2	180		530
Sept. 30	Invoice from supplier	L2	280		810
Dec. 31	Estimated accrual	L3	340		1,150
Dec. 31	Transfer to profit and loss account	L5		(1,150)	nil

LEONA: *The electricity account for the year shows a full 12 months' expense which is transferred to the profit and loss account at the end of the year.*

L2 Liability to supplier

Date	*Particulars*	*Page*	*Debit*	*Credit*	*Balance*
Year 1			£	£	£
Mar. 31	Invoice for electricity expense	L1		350	(350)
Apr. 10	Cash paid	L4	350		nil
June 30	Invoice for electricity expense	L1		180	(180)
July 10	Cash paid	L4	180		nil
Sept. 30	Invoice for electricity expense	L1		280	(280)
Oct. 10	Cash paid	L4	280		nil

LEONA: *The supplier's account is showing a nil liability because all invoices received have been paid. We know there is another invoice on the way but the bookkeeping system is quite strict about only making entries in the ledger when the documentary evidence is obtained. The document in this case is the supplier's invoice. Until it arrives the liability has to be recognised as an accrual rather than in the supplier's account.*

L3 Accruals

Date	*Particulars*	*Page*	*Debit*	*Credit*	*Balance*
Year 1			£	£	£
Dec. 31	Estimate of electricity expense	L1	340	(340)	

LEONA: *The balance sheet will record a nil liability to the supplier but will show an accrual of £340 for electricity. When the supplier's invoice arrives in January of Year 2, the debit and credit entries will be:*

Date	*Transaction*	*Debit*	*Credit*
Year 2			
Jan. 4	Receive invoice for electricity £340	Accrual	Liability to supplier

In this way the liability remaining from Year 1 is recorded without affecting the expense account for Year 2. The credit balance on the accrual account at the end of Year 1 is eliminated by being matched against the debit entry at the start of Year 2.

S Test your understanding

S10.1 Prepare bookkeeping records for the information in question **B10.1**.

S10.2 Prepare bookkeeping records for the information in question **B10.2**.

S10.3 Prepare bookkeeping records for the information in question **B10.3**.

S10.4 Prepare bookkeeping records for the information in question **C10.1**.