Financial Accounting - 7

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Understanding Liabilities

Dear Friends, welcome back to the study of Financial Accounting. Please recall that we used a fictitious case study for an intuitive understanding of the three fundamental accounting statements. Next we undertook a more detailed understanding of the principles behind them, so that we may be able to apply them in our different circumstances. We followed the earlier pattern, where Bala Sir interacts with the ladies of a Self Help Group (SHG) to explain the theory. We learned in some detail the 'Balance Sheet Equation' and how to recognise 'Assets'. In this lesson, we shall learn to recognise liabilities more precisely.

We have added a few exercise questions at the end, so that the reader may try them out, as a self-check on their own comprehension.

Bala Sir now turned his attention to precise rules for recognition of liabilities. He told them, all of you know that liabilities are the opposite of assets. So why not simply reverse the rules for assets, and arrive at the rules for liabilities? If we do so, we get the following rules for recognition of any liability:

In order to qualify any item to be considered as a liability for a business, it must fulfil two conditions:

1. There must be a past or recent transaction giving rise to the creation of this liability *(This condition remains the same)*, and
2. As a result of this liability, the business must expect to lose some future value. This could be either a decrease in *future* cash inflow or an increase in *future* cash outflow. The amount of this future value should be known.

As in the case of assets, Bala Sir proceeded to take examples from their own experience. For the sake of convenience, we reproduce the transactions again.

> "APS was now ready to start their store, and rented a shop on the roadside, and paid Rs. 12,000 in advance, as rental for one year on October 7th. They bought some essential items like storage shelves, weighing scales, a packing machine, a table and chair, a cash register, a tri-cycle for home delivery, etc. costing Rs. 120,000. They also purchased from the wholesale market, all groceries that they expected to sell over a month, at a total cost of Rs. 200,000. The wholesaler accepted a down payment of 50% of the amount, and agreed to extend a credit period of 30 days for the balance.

> For the sake of simplicity, we shall assume that by the end of the month, APS was able to sell merchandise worth 180,000 at a price of Rs. 240,000, but Rs. 40,000 was sold on credit, and they received cash of Rs. 200,000 for the sales.
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> "During the month, they paid an electricity bill for Rs. 1000. They had engaged a full-time assistant to help them in the stores on a monthly salary of Rs. 7500. Each member took turns in assisting the running of the store, like supervision and training, pre-packing, home delivery, sorting and cleaning etc. They decided to charge the store a monthly remuneration of Rs. 2,500 each for this service. All the salaries, including those charged to themselves for their services were paid at the end of the month".

Let us consider each item one by one.

1. APS paid Rs. 12,000 in advance, as rental – this was a case of creation of an asset – pre-paid rent.
2. APS bought some furniture and fixtures costing Rs. 120,000. This was yet another case of asset creation.
3. APS purchased groceries worth Rs. 200,000, with a down payment of 50% and a credit period of 30 days for the balance. We have noted the creation of an asset, as a result of this transaction, but is that all? Bala Sir asked. Urmila said, "APS didn't pay the full amount, and owed the wholesaler Rs. 100,000 to be paid within 30 days. This looks like a liability". Bala Sir agreed, but asked Urmila to justify her point citing the rules. Urmila said, "The first condition – that of a transaction – is fulfilled. The second condition - *future cash outflow* – is also fulfilled as we know that APS has to pay back Rs. 100,000 within 30 days". Bala Sir was very happy with her answer.
4. Next transaction: APS sold merchandise worth 180,000 at a price of Rs. 240,000, but Rs. 40,000 was sold on credit, and they received cash of Rs. 200,000 for the sales. We have discussed this in detail, and this was the case of creation of an asset.
5. Bala Sir now listed the remaining transactions for their analysis, as under:
    a. APS paid an electricity bill for Rs. 1000
    b. APS engaged a full-time assistant to help them in the stores on a monthly salary of Rs. 7500
    c. APS would charge the store a monthly remuneration of Rs. 2,500 each
    d. All the salaries, including those charged to themselves for their services were paid at the end of the month.

Do these transactions give rise to any liabilities? Well, as long as the electricity bill was unpaid, and APS had consumed electricity, a liability did arise, but now that the bill has been paid, there is no future cash outflow expected.

Engaging the stores assistant meant a promise of paying the monthly salary, *for the services rendered.* At the time of engagement, no service had yet been rendered, therefore there was no liability.

The same argument applies for their own remunerations.

Finally, all accrued salary and remunerations were paid at the end of the month, and therefore, even though there was a liability – unpaid wages and remunerations *before the payments were made,* now, after the payments, there is no liability.

Uma asked, "So, how do we keep record of these transactions?"

'Excellent question', Bala Sir said. We shall record all of them as expenses, as we shall see later.

6. Bala Sir now asked them, have we completed all possible cases of creation of liabilities, or are we missing something. What about our bank loan, all of them shouted together. Bala Sir was happy to note that the women were making good progress. He even thought that some of them were perhaps equal or even better than some of his BBA students. He decided to recall the transactions they had from the very beginning, and take up each one of them. For convenience, those transactions are reproduced below:

    > Mr. Selvaraj, happily agreed, and prepared an initial estimate of Rs. 400,000 for the project. He said that they must put forth 15% of the total cost from their own resources, before any bank could extend them a loan for the remaining amount. That meant, they had to invest Rs. 60,000 in total, and they agreed to share this equally, everyone paying Rs. 6,000 towards the business. So, on October 1st, 2021, they contributed Rs. 6000 each, and opened an account with the local bank in the name of Arathi Provision Stores (APS). Selvaraj explained to them that they were the owners of APS, and each one of them owned 6000 shares each. The value of each share was Re. 1/= only. The bank agreed to extend a loan of Rs. 340,000 on October 5th at an annual interest rate of 12%.

    As usual, let us consider each item or transaction separately.

    On October 1st, 2021, they contributed Rs. 6000 each, and opened an account with the local bank in the name of Arathi Provision Stores (APS).

    Does this create any liability for APS? We apply the rules. The first rule is satisfied – a transaction is done. What about the second rule? APS has an obligation to each one of them, of an amount of Rs. 6000. In recognition of this claim, APS *issued 6000 shares each, valued at Re. 1 per share.* Therefore, a special liability – known as Shareholders' Equity is created, amounting to Rs. 60,000. Bala Sir explained that this liability is rather special, as it represents the liability towards the owners themselves, and it is customary to keep an account of them separately, for reasons we shall learn very soon.

7. Next transaction - The bank extended a loan of Rs. 340,000 on October 5th at an annual interest rate of 12%.

    All of them had already identified this to be a liability, and now Bala Sir asked them to re-confirm the same, applying all the rules, to be safe. They agreed, and noted that a transaction had taken place, and APS had a liability to pay back the loaned amount to the bank *with interest.* So, what was the exact amount of the liability? Well, on October 5th, it was just Rs. 340,000, because no interest had accumulated yet. As and when time passes, and APS does not return the loan, interest would accrue, and accordingly liabilities would arise.

8. Now it is the end of the month. Therefore, as on October 31st, APS has an interest payable liability of Rs. 3400 (1% of 340,000 as interest for 1 month). The ladies realised that time is money, but in the wrong sense, in this case!

We reproduce our balance sheet below, in order to confirm that we have correctly recorded all assets and liabilities.

APS Balance Sheet (As on October 31, 2021)			
Assets	Amount	Liabilities	Amount
Cash	334,500	Bank loan	340,000
Furniture and Fixtures	118,000	Interest payable	3,400
Prepaid rent	11,000	Accounts payable	100,000
Merchandise inventory	20,000	Shareholders' equity	60,000
Accounts receivable	40,000	Retained Earnings	20,100
Total	523,500	Total	523,500

We note that two items were not discussed earlier.

On the assets side, we missed out on cash. From our cash flow statement, we get the ending cash balance as 334,500.

From our Income and expenditure statement, we get an ending result of the month's business operations – a surplus of Rs. 20,100. We call this Retained Earnings. Once these two missing items are inserted, we get the balance.

Exercises

Please study the following situations and figure out if they create any liability for the business, and if so, how much. Please give a name to the liability.

1. A manufacturing company APL receives raw materials worth Rs. 150,000 from a supplier, with a condition that APL must pay the supplier within 30 days.
2. APL has finished the first half-year of its operations. Their tax consultants estimate that they have to pay an income tax of Rs. 300,000 for this period.
3. APL just signed a 3-year contract with a renowned professional manager, for a monthly salary of Rs. 500,000 and a joining bonus of Rs. 5,000,000 to lead its operations starting next week, as the current CEO is retiring.
4. APL has not paid its employees for the recently completed month as yet. Wages outstanding are Rs. 1,000,000.
5. APL gets caught in a controversy over compensation payments, and the claimant, being an influential person, files a court case against APL claiming a damage of Rs. 100,000.