ACC 1701X
Accounting for Decision Makers

Lecturer: Dr. Hanny Kusnadi

LECTURE 7 (PRE-RECORDED)

Cash & Current Liabilities

Goals for Today

Cash
(Chapter 6)

- Major activities of a business (LO1)
- Cash & internal controls (LO2)
- Buying & Selling: discounts & returns
  - Purchase transactions (part of LO3)
  - Sales transactions (Refer only to this lecture 07 slides)
- Bank Reconciliation (LO4)
- *Petty Cash (part of LO3) will **NOT** be covered .*

Current Liabilities
(Chapter 9, LO3 only)

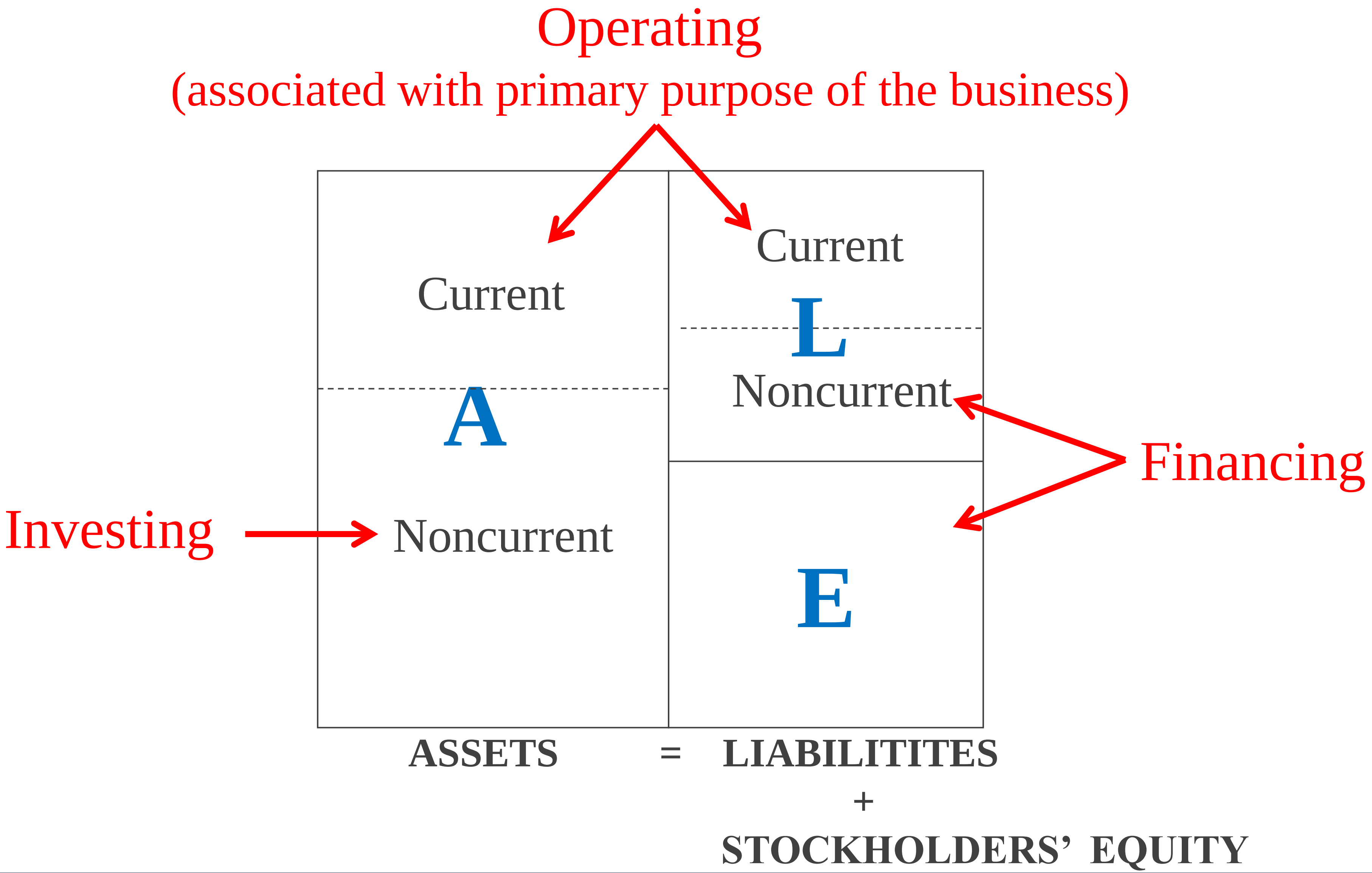
- Known Liabilities: (Refer only to this lecture 07 slides)
  - Accrued Liabilities: Sales Tax (GST), Payroll
  - Short Term Notes Payable
- Estimated Liabilities: (LO3)
  - Warranty provision
- Contingent Liabilities (LO3)

Goals for Today

Financial Analysis

- Current Ratio
- Acid Test Ratio

Statement of Financial Position & the 3 Major Activities of a Business



3 Major Activities & Cash Flows

Operating Activities:

- Cash inflow: Selling products or services
- Cash outflow: Buying inventory for resale, incurring and paying for necessary expenses (e.g. salaries, rent and utilities)

Investing Activities:

- Cash outflow: Purchase of assets (e.g. PPE, financial assets) for use in the business.
- Cash inflow: Disposal/Sale of assets

Financing Activities:

- Cash inflow: Borrowing money from creditors or raising money from investors
- Cash outflow: Repayment of debts or distributing cash dividends to shareholders

Cash, Cash Equivalents, and Liquidity

Cash and similar assets are called liquid assets because they can be readily used to settle near-term obligations.

Cash

Currency, coins and amounts on deposit in bank accounts, checking accounts, and some savings accounts. Also includes items such as customer checks, cashier checks, certified checks, and money orders.

Cash Equivalents

Short-term, highly liquid investments that are:

1. Readily convertible to known amounts of cash.
2. Subject to an insignificant risk of changes in value.

Internal Controls of CASH

Cash is the most susceptible to theft and fraud.

Internal control of cash is essential, and an effective system that protects cash should meet these guidelines:

(1) Separation of duties

- Complete separation of cash receipts functions and cash disbursement function.
- E.g. person receiving should be different from person disbursing cash

(2) Effective prescribed policies & procedures

- Proper cash handling procedure - Cash receipts are promptly deposited in the bank to prevent accumulation of cash on hand
- Separate approval of purchases & actual cash payments
- Cash disbursement by pre-numbered checks with different individuals for approval and check-signing
- Perform bank reconciliations periodically

Cash Management

The goals of cash management are twofold:

1. Plan cash receipts to meet cash payments when due.
2. Keep a minimum level of cash necessary to operate.

Effective cash management involves applying the following cash management principles:

- Encourage collection of receivables.
- Delay payment of liabilities.
- Keep only necessary levels of assets.
- Plan expenditures.
- Invest excess cash.

Buying and Selling Merchandise: Purchases & Sales

Purchase Merchandise

- Uniqlo purchase $10k worth of inventory merchandise. $6k was paid in cash, remaining on credit.

Inventory	$10,000	
Cash		$6,000
Accounts Payable		$4,000

- UniQlo pays supplier one month later:

Accounts Payable	$4,000	
Cash		$4,000

NOTE: Assume Uniqlo is on the perpetual inventory system. (We will cover inventory systems in the next lecture)

Merchandise Sales

- Uniqlo sold merchandise for $15k. $3k received in cash, remaining on credit. Cost of inventory is $10k.

Cash	$3,000	
Accounts Receivable	$12,000	
Sales Revenue		$15,000
COGS	$10,000	
Inventory		$10,000

Customer pays Uniqlo:

Cash	$12,000	
Accounts Receivable		$12,000

Credit Terms

Credit terms are often abbreviated in the following format:

2/10, n/30

Discount Percentage

Number of days discount is allowed

Net is due within credit period

Maximum Days in Credit Period

- It is read as "**Two ten, net thirty**" – meaning that there's a 2% discount if paid in 10 days from date of sale/invoice, otherwise the full price (net of return) is due in 30 days from date of sale/invoice.

Discounts:
Purchase Discounts & Sales Discounts

Purchase Discounts

- Uniqlo purchase $10k worth of inventory merchandise on credit.

Inventory	$10,000	
Accounts Payable		$10,000

- Assume credit term is 5/5, n/30, Uniqlo pays full amount within 5 days:

Accounts Payable	$10,000	
Inventory (5%x$10k)		$ 500
Cash		$9,500

Sales Discounts

- Uniqlo sold merchandise on credit for $15k.

Accounts Receivable	$15,000	
Sales Revenue		$15,000

(COGS entry not shown)

- Assume credit term given by Uniqlo to its customer is 3/10, n/45. Customer pays full amount within 10 days.

Cash	$14,550	
Sales discount (3%x$15k)	$ 450	
Accounts Receivable		$15,000

Returns:
Purchase Returns & Sales Returns

Purchase Returns

- Uniqlo returns merchandise worth $500 previously bought on credit, to its supplier:

Accounts Payable	$500	
Inventory		$500

Sales Returns

- A customer who had earlier bought merchandise on credit, returned part of the merchandise to Uniqlo. The returned item was originally sold for $200 and cost $70 to Uniqlo.

Sales Returns	$200	
Accounts Receivable		$200
Inventory	$70	
Cost of Goods Sold		$70

Merchandise Sales –
Contra-revenue & Net Sales

- Sales Discounts & Returns are **contra-revenue** accounts
- Contra-revenue accounts:
  - To track negative adjustments to sales
  - Reduces revenue (so it's like an expense)
  - Has a normal **debit** balance
- On the Income Statement, it is deducted away from gross revenue to get Net Sales Revenue. For example:

Sales Revenue	**$100,000**
Less: Sales discounts & returns	**($7,800)**
Net Sales	**$92,200**

Controls from Bank Procedures

Banks provide important services that help businesses to control cash:

- Restricting access
- Documenting procedures
- Independently verifying

Basic Bank Services:

- Bank Accounts
- Signature Cards
- Checks
- Electronic Funds Transfer
- Bank Statements

What is a Bank Statement?

FN First National
Hillcrest, New York 11750

Bank Statement

Member FDIC

VideoBuster Company
901 Main Street
Hillcrest, NY 11749

October 31, 2020
Statement Date

494 504 2
Account Number

A

Previous Balance	Total Checks and Debits	Total Deposits and Credits	Current Balance
1,609.58	723.00	1,163.42	2,050.00

B — Checks and Debits

Date	No.	Amount
10/03	119	55.00
10/09	120	200.00
10/10	121	120.00
10/12		23.00 DM
10/14	122	70.00
10/16	123	25.00
10/23	125	15.00
10/25		20.00 NSF
		10.00 DM
10/26	127	50.00
10/29	128	135.00

C — Deposits and Credits

Date	Amount
10/02	240.00
10/09	180.00
10/15	100.00 EFT
10/16	150.00
10/23	485.00 CM
10/31	8.42 IN

D — Daily Balance

Date	Amount
10/01	1,609.58
10/02	1,849.58
10/03	1,794.58
10/09	1,774.58
10/10	1,654.58
10/12	1,631.58
10/14	1,561.58
10/15	1,661.58
10/16	1,786.58
10/23	2,256.58
10/25	2,226.58
10/26	2,176.58
10/29	2,041.58
10/31	2,050.00

Symbols: **CM**–Credit Memo **EC**–Error Correction **NSF**–Non-Sufficient Funds **SC**–Service Charge
DM–Debit Memo **IN**–Interest Earned **EFT**–Electronic Funds Transfer **OD**–Overdraft

< Reconcile the account immediately. >

Usually once a month, the bank sends each depositor a bank statement showing the activity in the account:

(A) Summarize changes in the account

(B) Summarize checks paid and other debits* (withdrawals)

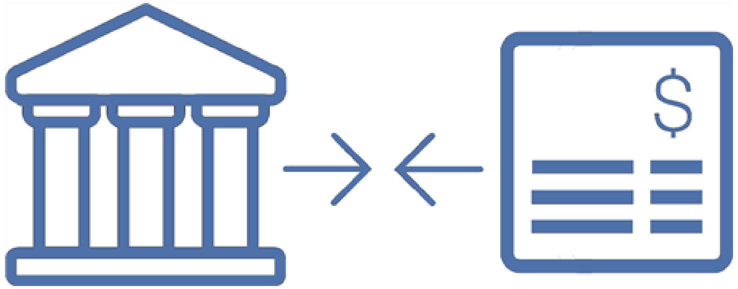
(C) Summarize deposits and other credits* (additions)

(D) Summarize the daily account balance

From the bank's perspective: deposits are liabilities to the bank hence referred to as credits in the bank statement, while customer withdrawals reduces the bank's liabilities hence referred to as debits.

What is a Bank Reconciliation?

A bank reconciliation is an internal report prepared to verify the accuracy of both the bank statement and the cash accounts of a business or individual.



Bank Reconciliation
Why bank statement balance is NOT equal to cash account?

Your Bank May Not Know About	You May Not Know About
1. Errors made by the bank 2. Time lag differences: a) <u>Deposit in transit</u>: deposits you made which has not been processed by the bank b) <u>Outstanding Checks</u>: checks you wrote but has not been processed by the bank	3. <u>Bank credits</u>: additions by the bank to your account. For example: interest income that the bank gives you. 4. <u>Bank Debits</u>: deductions by the bank. For example: bank service fees & charges taken out of your account. 5. <u>Direct deposits</u>: deposits made directly to your account. 6. <u>NSF checks</u>: customer checks you deposited for which the customer has insufficient funds. 7. Errors made by you

Bank Reconciliation Overview

Adjustment on the Bank Side	***Adjustment on the Book Side***
Bank Statement balance	**Book balance**
+ Deposits in transit	+ Interest paid by the bank
– Outstanding checks	+ Direct deposits
+/– Bank errors	– Service charges
	– NSF checks
	– Bank transfer
	+/– Accounting errors
Adjusted **Bank** Balance	Adjusted **Book** Balance

Account is reconciled when both the adjusted balances are equal.

Bank Reconciliation
VideoBuster Example

VideoBuster is performing a bank reconciliation for the month of October 2020.

1) Bank statement indicates an ending balance of $2,050 for the month of October 2020.

→ *Bank Statement Balance*

2) A deposit of $145 on Oct 31 was not shown on the bank statement. (It was in transit at the end of the month.)

→ *Deposit in transit*

3) Checks No.124 for $150, and No. 126 for $200 are outstanding.

→ *Outstanding checks*

4) Adjust the Bank Balance

VideoBuster Example
Adjusting the Bank side

9 simple steps to help you prepare a bank reconciliation:
Start with adjusting the bank side.

VIDEOBUSTER
Bank Reconciliation
October 31, 2020

①	Bank statement balance		$ 2,050.00
②	Add		
	Deposit of Oct. 31 in transit		145.00
			2,195.00
③	Deduct		
	Outstanding checks		
	No. 124	$150.00	
	No. 126	200.00	350.00
④	**Adjusted bank balance**		**$1,845.00**

(1) Cash Balance per Bank

(2) + Deposits in Transit

(3) - Outstanding Checks

+/- Errors

(4) Adjusted Cash Balance

Bank Reconciliation
VideoBuster Example (continued)

VideoBuster is performing a bank reconciliation for the month of October 2020.

5) The cash account in the general ledger shows a balance on Oct 31 of $1,404.58.

→ *Book Balance*

6) (i) Bank helped to collect $500 from VideoBuster's customer and automatically deducted $15 fees.

→ *Collections (direct transfer)*

(ii) The bank paid interest of $8.42 for the month of October.

→ *Interest paid by bank*

7) (i) A check of $20 was received from a customer T.Woods and deposited into the bank. However, the check was rejected as customer had insufficient funds. Bank also charged service fees of $10 for the returned check.

→ *NSF check and bank fees*

(ii) The bank charged $23 for printing of checks.

→ *Bank fees*

8) Adjust the Book Balance

VideoBuster Example
Adjusting the Book side

9 simple steps to help you prepare a bank reconciliation:
Next, adjust the book side.

VIDEOBUSTER
Bank Reconciliation
October 31, 2020

- (5) Cash Balance per Book
- (6) + Collections & Interest
- (7) - NSF checks & fees
- +/- Errors
- (8) Adjusted Cash Balance

⑤	Book balance		$ 1,404.58
⑥	Add		
	Collect $500 note less $15 fee	$485.00	
	Interest earned	8.42	493.42
			1,898.00
⑦	Deduct		
	Check printing charge	23.00	
	NSF check plus service fee	30.00	53.00
⑧	**Adjusted book balance**		**$1,845.00**

VideoBuster Example
Adjusted Bank = Adjusted Book

9 simple steps to help you prepare a bank reconciliation:

VIDEOBUSTER
Bank Reconciliation
October 31, 2020

①	Bank statement balance		$ 2,050.00	⑤	Book balance		$ 1,404.58
②	Add			⑥	Add		
	Deposit of Oct. 31 in transit		145.00		Collect $500 note less $15 fee	$485.00	
			2,195.00		Interest earned	8.42	493.42
③	Deduct						1,898.00
	Outstanding checks			⑦	Deduct		
	No. 124	$150.00			Check printing charge	23.00	
	No. 126	200.00	350.00		NSF check plus service fee	30.00	53.00
④	**Adjusted bank balance**		**$1,845.00**	⑧	**Adjusted book balance**		**$1,845.00**

⑨ Balances are equal (reconciled)

(9) Adjusted Bank Balance = Adjusted Book Balance

VideoBuster Example
Adjusting Entries for the Books

After performing your bank reconciliation, you need to record **adjusting entries** for the reconciling items on the **book side of the reconciliation**:

Direct transfer received from customer and related bank service charge:

Oct. 31	Cash	485	
	Collection Expense.	15	
	Notes Receivable		500
	To record the collection fee and proceeds for a note collected by the bank.		

Interest Revenue:

Oct. 31	Cash	8.42	
	Interest Revenue.		8.42
	To record interest earned on the cash balance in the checking account.		

Miscellaneous bank charges:

Oct. 31	Miscellaneous Expenses	23	
	Cash		23
	Check printing charge.		

Customer (T.Woods) check rejected as NSF plus the service fee of $10:

Oct. 31	Accounts Receivable—T. Woods.	30	
	Cash		30
	To charge Woods' account for $20 NSF check and $10 bank fee.		

Self-study Question : E 6-10

We will work through the assigned self-study question E6-10 together.

(Refer to the excel sheet solution file in Canvas)

E 6-10

LO 4

Preparing a Bank Reconciliation

Prepare a bank reconciliation for Bend Company at January 31, 2022, using the information shown.

1. Cash per the accounting records at January 31 amounted to $228,909; the bank statement on this same date showed a balance of $204,008.
2. The canceled checks returned by the bank included a check written by DeVoe Company for $6,987 that had been deducted from Bend's account in error.
3. Deposits in transit as of January 31, 2022, amounted to $33,442.
4. The following amounts were adjustments to Bend Company's account on the bank statement:
   a. Service charges of $64.
   b. An NSF check of $4,100.
   c. Interest earned on the account, $110.
5. Checks written by Bend Company that have not yet been cleared by the bank include four checks totaling $19,582.

Goals for Today

Cash
(Chapter 6)

- Major activities of a business (LO1)
- Cash & internal controls (LO2)
- Buying & Selling: discounts & returns
  - Purchase transactions (part of LO3) – brief recap as this was covered in lecture 06
  - Sales transactions (Refer only to this lecture 07 slides)
- Bank Reconciliation (LO4)
- *Petty Cash (part of LO3) will NOT be covered .*

Current Liabilities

- Known Liabilities: (Refer only to this lecture 07 slides)
  - Accrued Liabilities: Sales Tax (GST), Payroll
  - Short Term Notes Payable
- Estimated Liabilities: (LO3)
  - Warranty provision
- Contingent Liabilities (LO3)

Liabilities (RECAP)

- A **present** debt or obligation
- As a result of **past** transactions or events
- To be **paid in the future** with assets or services
- Can be **measured** with reasonable precision
- Liabilities are recorded at their current cash equivalent, which is the cash amount a creditor would accept to settle the liability immediately.

OUR FOCUS!

Maturity = 1 year or less — **Current Liabilities**

Maturity > 1 year — **Noncurrent Liabilities**

3 Major Uncertainties in Liabilities

Uncertainty in:

WHOM to pay

WHEN to pay

HOW MUCH to pay

- **Known Liabilities** – little uncertainty: who, when and how much is determinable.
- **Estimated Liabilities** – a known obligation of an uncertain amount, but one that can be reliably estimated.
- **Contingent Liabilities** – *potential* obligation created as a result of a past event, but which is not yet an effective liability until some future event happens.

Current Liabilities

Types of "Known" Current Liabilities

Account Name	Also known as	Definition
Accounts Payable	Trade Payable	Obligations to pay for goods or services used in the basic operating activities of the business.
Accrued Liabilities	Accrued Expenses	Expenses already incurred but not yet paid *e.g. Accrued Taxes Payable, Accrued Wages*
Deferred Revenues	Unearned Revenues	Revenues not earned, but company already receive payment in advance. It's a liability until the company renders the goods or services.
Short Term Notes Payable		Obligations supported by a formal written contract.
Current Portion of Long-term Debt		Part of a long-term debt that is due within a year.

“Known” Current Liabilities
Accounts Payable (RECAP)

- Amounts owed to suppliers for products or services purchased on credit in the normal course of operations.
- Purchasing inventory merchandise on credit:

  DR Inventory

  CR Accounts Payable

- Incurring operating expense on credit (e.g. repairs, utilities, fees etc…):

  DR Expense

  CR Accounts Payable

“If an invoice is due in 30 days, we pay it in 60 days. If it’s due in 60 days, we pay it in 90 days. If it’s due in 90 days, then they probably don’t need the money anyway.”

“Known” Current Liabilities
Accrued Taxes : Sales Tax Payable

- Sales taxes – tax on retail sales
- Also known as “***goods and services taxes (GST)***” in Singapore
- When merchandise retailers sell goods, they collect sales tax which they are obligated to pay to the taxation authorities → current liability
- Recording $10,000 sale transaction with GST (7%)

Cash/Accounts Receivable	$10,700	
Sales Revenue		$10,000
GST Payable (7% x $10,000)		$700

- Recording payment of GST to the Inland Revenue Authority of Singapore (IRAS):

GST Payable	$700	
Cash		$700

"Known" Current Liabilities
Payroll Liabilities: CPF contributions

- Employers incur expenses and liabilities from having employees – payroll expenses
- Some are amounts withheld from employee's wages by the employer and to be paid by the employer on the employee's behalf to the relevant authorities (e.g. employee's CPF contribution @ 20%)

E.g.	Salaries Expense	$10,000	
	Salaries Payable – to employee		$8,000
	CPF Payable – employee contribution		$2,000

- Some are amounts borne by the employer as part of employment and are costs to the employer (e.g. Employer's CPF contribution @ 17%)

E.g.	Payroll Expense – CPF	$1,700	
	CPF Payable – employer contribution*		$1,700

** Assuming salaries expense of $10,000*

"Known" Current Liabilities Unearned Revenue (RECAP)

- Amounts received in advance from customers for future products or services.
- Receiving payment in advance of $12,000 for goods yet to be delivered / services yet to be rendered:

Cash	$12,000	
Unearned Revenues		$12,000

- Recognizing revenue upon delivery of goods / performance of services* (assuming only half of the goods/services from above is rendered):

Unearned Revenues	$6,000	
Sales Revenue		$6,000

**Recall that this is typically entered as your adjusting journal entry (AJEs)*

Real FS
Tencent's Current Liabilities

- Let's go through Tencent 2021 current liabilities:

	Note	As at 31 December 2021 RMB'Million	2020 RMB'Million
Current liabilities			
Accounts payable	40	**109,470**	94,030
Other payables and accruals	41	**60,582**	54,308
Borrowings	36	**19,003**	14,242
Current income tax liabilities		**12,506**	12,134
Other tax liabilities		**2,240**	2,149
Other financial liabilities	39	**3,554**	5,567
Lease liabilities	18	**5,446**	3,822
Deferred revenue	5(c)(i)	**87,846**	82,827
Dividends payable for distribution in specie	15(b)	**102,451**	–
		403,098	269,079

“Known” Current Liabilities
Short-Term (ST) Notes Payable

- A formal written promise to pay a specified on a definite future date within one year
  - To the lender, interest is a revenue.
  - To the borrower, interest is an expense.

Interest = Principal × Interest Rate × Time Period*

- For example: Lenovo borrows $100,000 for 60 days at an annual interest rate of 12%. Interest on the note is:

Interest = Principal x Interest Rate x Time

$$= \$100{,}000 \times 12\% \times \frac{60}{360}$$

$$= \$2{,}000$$

- *Please use 360 days for one year time period when calculating the daily interest. Refer to next slide for details on how to calculate the actual days for interest.*

ST Notes Payable
How to calculate the interest days under Actual/360

- Steps in using the Actual/360 convention to calculate interest:
  (1) Annual interest rate is divided by ***360 days*** to get the daily interest
  (2) Daily interest rate is multiplied by the ***actual*** number of days in the month that the note is outstanding for.

- E.g. For a 180 days Notes dated November 13th, the days for interest each month is:
  - November: 17 days (30-13=17)
  - December: 31 days
  - January: 31 days
  - February: 28 days (assuming 28 days in February)
  - March: 31 days
  - April: 30 days
  - May: 12 days (180-17-31-31-28-31-30=12)

    Due date of the Note is on May 12th.

Trivia Q : If you are calculating interest using Actual/365 method (i.e. daily interest is calculated using 365 days), does this method gives you a HIGHER or LOWER interest expense?

ST Notes Payable
Logic Co Example

- Notes can arise when companies borrow money from an external party.
  - On Feb 1st 2020, Logic Company borrows $7,000 from one of its business partner, Generous Co. at 10% interest for 180 days. The entry to record the transaction is:

Cash	$7,000	
Notes Payable – Generous Co.		$7,000

  - When Logic repays the note plus interest to Generous Co, it will record:

Notes Payable – Generous Company	$7,000	
Interest Expense (10% x $7k x 180/360)	$350	
Cash		$7,350

- *Notes can also arise from conversion of an accounts payable to a notes payable.*

ST Notes Payable: End-of-Period Adjustments
Logic Co Example

- If a short-term note payable is issued in one accounting period but is not payable until the following accounting period, an adjusting entry at year-end to record the accrued interest expense is needed.
- E.g. On Nov 16^{th} 2020, Logic Company borrows \$9,600 from a bank at 15% interest for 120 days. At Dec 31^{st} 2020, an adjusting entry is needed to record interest expense for 45 days (14 days in November + 31 days in December):

Interest Expense (15% x \$9.6k x 45/360)	\$180	
Interest Payable		\$180

- On March 16^{th} 2021, Logic repays the note principal plus interest:

Interest Expense (15% x \$9.6k x 75/360)	\$300	
Interest Payables	\$180	
Notes Payable	\$9,600	
Cash		\$10,080

Estimated Liabilities
Warranty

- Estimated liabilities - a <u>known obligation</u> of an *uncertain amount*, but one that can be *reliably estimated*.
- **Warranty Liabilities:**

> Seller's obligation to replace or correct a product (or service) that fails to perform as expected within a specified period. To comply with the full disclosure and matching principles, the seller reports ***expected warranty expense*** in the period when revenue from the sale is reported.

- Warranty expense must be recorded in the same period as the sales revenue
- Warranty expense is an estimation (e.g. based on past experience with warranties)

Recording Warranty Liabilities
Rimowa Example

- On 15th Nov 2020, Rimowa sold luggage for $50,000 with a 5 years warranty covering parts. Past experience indicates that warranty expenses average about 3% of the luggage's selling price.

Warranty Expense (3% x $50k)	$1,500	
Warranty Provision		$1,500

- On Aug 24th 2021, a customer returns a luggage for repairs, which costs Rimowa $120 in replacement parts.

Warranty Provision	$120	
Parts Inventory		$120

Real FS - TESLA
Warranty Provision (Accrued Warranty)

- Tesla's 2022 Financial Statements – Warranties (partial extract) TESLA

Warranties

We provide a manufacturer's warranty on all new and used vehicles and a warranty on the installation and components of the energy generation and storage systems we sell for periods typically between 10 to 25 years. We accrue a warranty reserve for the products sold by us, which includes our best estimate of the projected costs to repair or replace items under warranties and recalls if identified. 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, and changes to our historical or projected warranty experience may cause material changes to the warranty reserve in the future. The warranty reserve does not include projected warranty costs associated with our vehicles subject to operating lease accounting and our solar energy systems under lease contracts or PPAs, as the costs to repair these warranty claims are expensed as incurred. 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 sheets. Warranty expense is recorded as a component of Cost of revenues in the consolidated statements of operations. Due to the magnitude of our automotive business, accrued warranty balance is primarily related to our automotive segment. Accrued warranty activity consisted of the following (in millions):

	Year Ended December 31,		
	2021	2020	2019
Accrued warranty—beginning of period	$ 1,468	$ 1,089	$ 748
Warranty costs incurred	(525)	(312)	(250)
Net changes in liability for pre-existing warranties, including expirations and foreign exchange impact	102	66	36
Provision for warranty	1,056	625	555
Accrued warranty—end of period	$ 2,101	$ 1,468	$ 1,089

For Tesla's 2022 Annual Financial Statements, refer to its 10-K filing with the SEC:
https://www.sec.gov/Archives/edgar/data/1318605/000095017022000796/tsla-20211231.htm

Real FS – TESLA
Current & Long Term Accrued Warranty

Note 9 – Accrued Liabilities and Other

Our accrued liabilities and other current liabilities consisted of the following (in millions):

	December 31, 2021		December 31, 2020	
Accrued purchases (1)	$	2,045	$	901
Taxes payable (2)		1,122		777
Payroll and related costs		906		654
Accrued warranty reserve, current portion		703		479
Sales return reserve, current portion		265		417
Operating lease liabilities, current portion		368		286
Accrued interest		16		77
Other current liabilities		294		264
Total	$	5,719	$	3,855

Current portion $703
LT portion $1,398
Total $2,101

Note 10 – Other Long-Term Liabilities

Our other long-term liabilities consisted of the following (in millions):

	December 31, 2021		December 31, 2020	
Operating lease liabilities	$	1,671	$	1,254
Accrued warranty reserve		1,398		989
Sales return reserve		133		500
Deferred tax liability		24		151
Other non-current liabilities		320		436
Total other long-term liabilities	$	3,546	$	3,330

Contingent Liabilities

- Contingent liabilities are **potential** liabilities that are created as a result of a past event. It is not an effective liability until some future event happens.
  - E.g. lawsuits and litigation (legal claims), debt guarantees
- **When to record a contingent liability?**

	Probable	Reasonably Possible	Remote
Estimable	**Record as Liability**	Disclose in Notes	No disclosure needed
Non-estimable	Disclose in Notes	Disclose in Notes	No disclosure needed

The probabilities of occurrence are defined in the following manner:

1. Probable—the chance that the future event or events will occur is high; >50% (IFRS), > 70% (GAAP)
2. Reasonably possible—the chance that the future event or events will occur is more than remote but less than likely.
3. Remote—the chance that the future event or events will occur is slight.

Real FS – BP
Contingent Liabilities & Provisions

- BP 2021 Annual Report – Note 1 (Significant accounting policies, judgements, estimates & assumptions)

A contingent liability that is (1) probable and (2) estimable, will be recorded as a liability (provision)

Provisions and contingencies

Provisions are recognized when the group has a present legal or constructive obligation as a result of a past event, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and a reliable estimate can be made of the amount of the obligation. Where appropriate, the future cash flow estimates are adjusted to reflect risks specific to the liability.

If the effect of the time value of money is material, provisions are determined by discounting the expected future cash flows at a pre-tax risk-free rate that reflects current market assessments of the time value of money. Where discounting is used, the increase in the provision due to the passage of time is recognized within finance costs. Provisions are discounted using a nominal discount rate of 2.0% (2020 2.5%).

Provisions are split between amounts expected to be settled within 12 months of the balance sheet date (current) and amounts expected to be settled later (non-current).

Contingent liabilities are possible obligations whose existence will only be confirmed by future events not wholly within the control of the group, or present obligations where it is not probable that an outflow of resources will be required or the amount of the obligation cannot be measured with sufficient reliability. Contingent liabilities are not recognized in the consolidated financial statements but are disclosed, if material, unless the possibility of an outflow of economic resources is considered remote.

Real FS – BP
Contingent Liabilities & Provisions

Group balance sheet

At 31 December	Note	2021	$ million 2020
Current liabilities			
Trade and other payables	21	**52,611**	36,014
Derivative financial instruments	29	**7,565**	2,998
Accruals		**5,638**	4,650
Lease liabilities	27	**1,747**	1,933
Finance debt	25	**5,557**	9,359
Current tax payable		**1,554**	1,038
Provisions	22	**5,256**	3,761
		79,928	59,753
Liabilities directly associated with assets classified as held for sale	2	**359**	46
		80,287	59,799
Non-current liabilities			
Other payables	21	**10,567**	12,112
Derivative financial instruments	29	**6,356**	5,404
Accruals		**968**	852
Lease liabilities	27	**6,864**	7,329
Finance debt	25	**55,619**	63,305
Deferred tax liabilities	8	**8,780**	6,831
Provisions	22	**19,572**	17,200
Defined benefit pension plan and other post-retirement benefit plan deficits	23	**7,820**	9,254
		116,546	122,287
Total liabilities		**196,833**	182,086

Real FS – BP
Contingent Liabilities & Provisions

22. Provisions

$ million

	Decommissioning	Environmental	Litigation and claims	Emissions	Other	Total
At 1 January 2021	14,476	1,629	910	1,669	2,277	20,961
Exchange adjustments	(25)	(10)	(4)	(39)	(76)	(154)
Increase (decrease) in existing provisions[a]	1,231	363	226	2,900	623	5,343
Write-back of unused provisions[a]	(18)	(55)	(90)	(23)	(304)	(490)
Unwinding of discount[a]	331	36	14	—	10	391
Change in discount rate	1,252	41	33	—	6	1,332
Utilization	(72)	(259)	(188)	(754)	(642)	(1,915)
Reclassified to other payables	(257)	—	(67)	—	(16)	(340)
Reclassified as liabilities directly associated with assets held for sale	—	—	—	—	(47)	(47)
Deletions	(253)	—	—	—	—	(253)
At 31 December 2021	16,665	1,745	834	3,753	1,831	24,828
Of which – current	609	277	112	3,481	777	5,256
– non-current	16,056	1,468	722	272	1,054	19,572

[a] Recognized in the Group income statement

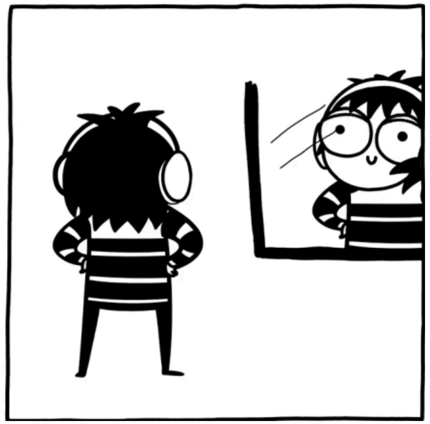
The decommissioning provision comprises the future cost of decommissioning oil and natural gas wells, facilities and related pipelines. The environmental provision includes provisions for costs related to the control, abatement, clean-up or elimination of environmental pollution relating to soil, groundwater, surface water and sediment contamination. The litigation and claims category includes provisions for matters related to, for example, commercial disputes, product liability, and allegations of exposures of third parties to toxic substances. Emissions provisions primarily relate to obligations under the U.S. Environmental Protection Agency Renewable Fuel Standard Program and are driven by the amount of the obligations outstanding and current price of the related credits. The provision will principally be settled through allowances already held as inventory in the group balance sheet.

For information on significant estimates and judgements made in relation to provisions, see Provisions and contingencies within Note 1.

Goals for Today

Financial Analysis

- Current Ratio
- Acid Test Ratio



"The liabilities are always 100% good! It's the assets you have to worry about."

- Charlie Munger

Assessing Liquidity
Current Ratio

Current Ratio

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

- Measures the ability of a company to pay its short-term obligations with short-term assets. The higher the ratio, the better a firm's liquidity is.
- Liquidity refers to how easily an asset can be converted to cash.
- However, a ratio that is too high might indicate that a firm is not using its resources efficiently.

Current Ratio
An example: ComfortDelGro

	Note	The Group 2021 $'mil	The Group 2020* $'mil
ASSETS			
Current assets			
Short-term deposits and bank balances	4	919.1	742.8
Trade and other receivables	5	536.9	533.4
Due from subsidiaries	6	–	–
Grant receivables	12	0.6	20.1
Inventories	7	116.9	127.9
		1,573.5	1,424.2
Assets classified as held for sale	43	8.3	–
Deferred tax assets	16	6.5	–
Total current assets		1,588.3	1,424.2
Current liabilities			
Borrowings	17	23.9	110.3
Lease liabilities from financial institutions	18	28.0	30.7
Lease liabilities	19	33.3	32.6
Trade and other payables	20	775.6	675.0
Due to subsidiaries	20	–	–
Deferred grants	21	0.6	30.5
Fuel price equalisation account		20.0	20.0
Provision for accident claims	22	44.3	48.7
Income tax payable		64.4	64.7
Total current liabilities		990.1	1,012.5

ComfortDelGro	**2021**	**2020**	**2019**
Current Assets (CA)	1,588	1,424	1,319
Current Liabilities (CL)	990	1,013	1,116
Current Ratio (CA/CL)	**1.60**	**1.41**	**1.18**

COMFORTDELGRO

Current Ratio
ComfortDelGro vs Uber

Let's compare ComfortDelGro with its competitor Uber:

ComfortDelGro	**2021**	**2020**	**2019**
Current Assets	1,588	1,424	1,319
Current Liabilities	990	1,013	1,116
Current Ratio	**1.60**	**1.41**	**1.18**

Uber *(in mil $)*	**2021**	**2020**	**2019**
Current Assets	8,819	9,882	13,925
Current Liabilities	9,024	6,865	5,639
Current Ratio	**0.98**	**1.44**	**2.47**

- Uber's current ratio in 2019 is <u>double</u> that of ComfortDelGro (2.47 vs. 1.18). Why do you think its current ratio in 2019 is so high?
- In 2020, ComfortDelGro's current ratio is similar to Uber at about 1.4. They are both similar in terms of liquidity in 2020.
- However, in 2021 Uber's current ratio dropped to below 1, while ComfortDelGro's increased to 1.6.

Uber:
Beyond the Ratio – Digging deeper into the FS

Why is Uber's 2019 current ratio so high? Why did it continue to drop in 2020 and 2021?

Look into the details, dig into the FS:

- Uber had a lot of cash in 2019: $10.8b. Because it raised almost $8b cash from issuance of stock at IPO, $1b cash from issuance of subsidiary preferred stock, $1b cash from debt

➔Lots of cash went into the company. High cash contributes to its high current asset in 2019.

- Uber is not profitable, its operations is burning cash:
  - In 2020, its cash flow from operating activities is negative $2.75b, from investing activities it is negative $2.87b. Even though it raised $2.63b in debt in 2020, the net cash still decreased by $4.3b!
  - In 2021, its total cash flow from operating activities and investing activities is negative $1.6b. Cash reduced by $1.4 b from 2020 to 2021, yet its current liabilities went up by almost $2.2b.

➔Current ratio keeps dropping in. In 2021, it was below 1.

- Further considerations:
  - Uber has a lot of debt, LT debt at 2021 year end is $9.2b! Eventually they must be repaid.
  - What happens if/when the cash runs out?

Uber

Acid-Test Ratio

$$\text{Acid-Test Ratio} = \frac{\text{Quick Assets}}{\text{Current Liabilities}}$$

- Quick Assets = Cash + Short term investments + Current trade receivables
- Measures a company's ability to quickly pay its short term obligations using liquid assets (exclude inventory, prepaids and other current assets that are less liquid)
- Also known as "**Quick Ratio**"
- Useful to assess if company will face near term liquidity problems

Acid Test Ratio (Quick Ratio)
An example: ComfortDelGro

	Note	The Group 2021 $'mil	The Group 2020* $'mil
ASSETS			
Current assets			
Short-term deposits and bank balances	4	919.1	742.8
Trade and other receivables	5	536.9	533.4
Due from subsidiaries	6	–	–
Grant receivables	12	0.6	20.1
Inventories	7	116.9	127.9
		1,573.5	1,424.2
Assets classified as held for sale	43	8.3	–
Deferred tax assets	16	6.5	–
Total current assets		1,588.3	1,424.2
Current liabilities			
Borrowings	17	23.9	110.3
Lease liabilities from financial institutions	18	28.0	30.7
Lease liabilities	19	33.3	32.6
Trade and other payables	20	775.6	675.0
Due to subsidiaries	20	–	–
Deferred grants	21	0.6	30.5
Fuel price equalisation account		20.0	20.0
Provision for accident claims	22	44.3	48.7
Income tax payable		64.4	64.7
Total current liabilities		990.1	1,012.5

ComfortDelGro	2021	2020	2019
Quick Assets*	1,301	1,143	913
Current Liabilities	990	1,013	1,116
Acid Test Ratio	**1.31**	**1.13**	**0.82**

** QA = Cash and short term deposits + trade receivables (refer to Note 5 of the FS).*

A common rule of thumb is the acid-test ratio should have a value of at least 1.0 to conclude a company is unlikely to face liquidity problems in the near future.

Acid Test Ratio
ComfortDelGro vs Uber

Let's compare ComfortDelGro with its competitor Uber:

ComfortDelGro	**2021**	**2020**	**2019**
Quick Assets	1,301	1,143	913
Current Liabilities	990	1,013	1,116
Acid Test Ratio	**1.31**	**1.13**	**0.82**

Uber *(in mil $)*	**2021**	**2020**	**2019**
Quick Assets	6,734	6,720	12,087
Current Liabilities	9,024	6,865	5,639
Acid Test Ratio	**0.75**	**0.98**	**2.14**

- Uber's quick ratio in 2019 is more than double of ComfortDelGro – 2019 was the year of IPO so Uber had plenty of proceeds coming in.
- But Uber had huge net cash outflow in 2020 and 2021, which resulted in the large drop in its quick asset. Its current liabilities is also increasing year after year.
- ComfortDelGro's acid test ratio on the other hand is improving from 2019 to 2022. Quick assets is increasing from 2019 to 2021 while current liabilities is decreasing.

Take Away for Lecture 07

- CASH:
  - Sales discounts & returns are contra-revenue accounts – as deduction to get Net Sales
  - Bank Reconciliation – reconciling bank statement balance with the book cash balance
- CURRENT LIABILITIES:
  - Known Liabilities (e.g. Accounts Payable, Sales Tax Payable, Payroll Liabilities, Unearned Revenue, Short Term Notes Payable)
  - Estimated Liabilities (e.g. Warranties/provision)
  - Contingent Liabilities
- FSA:
  - Current Ratio
  - Acid Test Ratio

See you next week!

NEXT WEEK: Chapter 8: INVENTORY

Post your questions on Canvas discussion forum.

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