CH 7 — Liabilities

Luke Lu • 2025-10-23

Current Liabilities

- Obligations due within one year
- Two types:

1. Known amounts :

Short-term borrowings	Accounts payable	Accrued liabilities
Short-term notes payable	Sales tax payable	Payroll liabilities
Income taxes payable	Unearned revenues	Current portion of long-term debt

2. Estimated amounts:

- Estimated Warranty Payable
- Contingent Liabilities: are possible obligation that will become actual obligation onluf if some uncertain future event occurs(e.g. lawsuit in progress)

Examples:

1. On October 1st, a business purchased inventory for $8000 by issuing a 6 month 10% note payable. The fiscal year ends on December 31st

ANS: Interest accrued $= \$8000 \cdot \frac{3}{12} \cdot 10\% = \$200$

2. Encore Records has two employees who are paid on the 1st and 15th of each month for the work they performed in the preceding half-month. At February 28, each employee is owed gross pay of $1,000, but each one must have 10% of their pay withheld for income taxes. Each must also make Canada Pension Plan contributions of 5.45% of their gross pay and pay. Employment Insurance premiums of 1.58% of their gross pay.

- Prepare the payroll journal entries required to reflect these amounts, along with Encore's share of CPP contributions and El premiums, in Encore's February 28 financial statements.
- Show what Encore would report on its February Balance Sheet and Income Statement.

ANS:

	Employee Portion					
Date	Account				Debit	Credit
28-Feb	Salary Expense				2000	
		Income Tax				200
		Canadian Pension Plan				109
		Employment Insurance				31.6
		Salary Payable				1659.4
	Employer Portion					
Date	Account				Debit	Credit
28-Feb	CPP Expense				109	
		CPP Payable				109
	EI Expense				44.24	
		EI Payable				44.24

3. GM of Canada Ltd. guarantees automobiles against defects for 5 years, or 160,000km, whichever comes first. Suppose GM expects warranty costs during the 5-year period to add up to 3% of sales. Assume that Forbes Motors in Waterloo, Ont. had sales of $2,000,000 on their Buick line during 2020. Forbes received cash for 10% of the sales and took notes receivable for the remainder. Payments to satisfy customer warranty claims totaled $50,000 during 2020.

- Record sales, warranty expense & warranty payments for Forbes.
- Post to the Estimated Warranty Payable T-account. The beginning balance was $40,000. At the end of 2020, how much in estimated warranty payable does Forbes owe its customers?
- What amount of warranty expense will Forbes report during 2020? Does the warranty expense for the year equal the year's cash payments for warranties? Explain the relevant accounting principle as it applies to measuring warranty expense.

ANS:

	Account			Debit	Credit
Y-2020	Cash			200000	
	Note Receivable			1800000	
		Revenue			2000000
	Warranty Expense			60000	
		Warranty Payable			60000
	Warranty Payable			50000	
		Cash			50000

Financial Business Activities:

- Using excess cash
- Issuing shares
- Borrowing money

Ratios

🐳 **Info** — Ratio

1. Account Payable Turnover = $\frac{\text{COG}}{\text{Average A/P}}$
2. Debt Ratio = $\frac{\text{Liabilities}}{\text{Assets}}$ (High ratio $\Longrightarrow$ more funded by debt)
3. Leverage Ration = $\frac{\text{Asset}}{\text{Shareholder's Equity}}$
   (High ration $\Longrightarrow$ more funded by equity)
4. Times Interest Earned = $\frac{\text{Operation income}}{\text{interest expense}}$ (High ratio $\Longrightarrow$ ease in paying interest)

Example:
Question: Refer to the slides

ANS:
1. Leverage Ratio $= \frac{100}{40} = 2.5$
2. Debt Ratio $= \frac{100-40}{100} = 0.6$
3. Times Interest Earned $= \frac{4.1}{1.1} = 3.73$

I would loan $ 1M to the company as the Times Interest Earned is ratehr high. That is for every $ of interest expense, the company arned $ 3.73 of income

Lululemon example

1. Leverage Ratio $= \frac{3.3}{7.6} = 0.43$
2. Debt ratio = $\frac{7.6}{4}, 3 = 1.77$
3. Times Interest Earned $= 5242$

Comparing these 2 companies, clearly Lululemon is a better investment option: lower Debt ratio and higher Times Interest Earned

Term Loans

- Like bonds, borrow a fixed amount that is repaid over several years at a specified interest rate
- Unlike bonds, typically arranged with single lender
- If secured by a real asset, referred to as a mortgage

Leases

- Operating: Lessor has all the risk and the reward of asset
- Financing: Lessee has all the risk and the reward of asset

Post Employment Benefit

- Forms of consideration given by a company in exchange for services rendered
- Recorded as liabilities on the balance sheet (current and long-term)
- Examples: pension benefits, medical and dental insurance, prescription drug benefits