Accounting and Current Liabilities

Current Liabilities: Introduction

A liability is an obligation of a company to pay in future for the present benefits or the acquisition of assets. Short term liabilities are those liabilities which become due within one year. Some of the common short term liabilities are: creditors, short term loans, outstanding expenses, lease liabilities, tax payable, and unearned incomes (income received but not due). Short term liabilities are generally called current liabilities. Table 9.1 shows financing by current liabilities of some of the well known companies of India:

Table 9.1					
Current Liabilities as % of Total Liabilities (Rs. Crore) as on 31 Mar 06					
Highest			Lowest		
A B B Ltd.	1372.87	58%	National Aluminium Co. Ltd.	607.33	8%
Siemens Ltd.	1275.9	45%	Tata Power Co. Ltd.	731.81	8%
Larsen & Toubro Ltd.	5896.28	45%	Gujarat Ambuja Cements Ltd.	288.98	7%
Hindustan Lever Ltd.	2959.43	44%	Sun Pharmaceutical Inds. Ltd.	166.18	5%
Bharat Heavy Electricals Ltd.	8810.68	43%	Reliance Communications Ltd.	612.62	4%

Source: CMIE Database

Creditors

When revenue goods are purchased on credit it results in a short term liability. Creditors is the money payable to the suppliers of revenue goods. Table 9.2 shows that quite a large percentage of total current liabilities of some of the well known companies are in the form of sundry creditors.

Table 9.2			
Sundry Creditors (Rs. In Crore) as on 31 March 2006			
Company Name	Current liabilities	Sundry creditors	as %
Tata Motors Ltd.	5903.36	5535.87	94%
Steel Authority Of India Ltd.	6100.87	2111.23	35%
Maruti Udyog Ltd.	1411.2	555.1	39%
Ranbaxy Laboratories Ltd.	728.56	570.46	78%
Larsen & Toubro Ltd.	5896.28	4062.61	69%
I T C Ltd.	2200.09	2152.76	98%
Infosys Technologies Ltd.	808	578	72%

Source: CMIE Database

Let us under stand how the creditors affect the accounting equation and the financial statements.

Example 9.1
ABC Ltd. started business with capital of Rs. 50,000 and 10% loan of 100,000. Table 9.3 shows the accounting equation.

Table 9.3		
Accounting Equation		
12% Loan+ 100,000	Capital = 50,000	Cash 150,000

Purchased goods worth of 25,000 on credit 25000. The accounting equation after the purchase is shown in Table 9.4

Table 9.4				
Accounting Equation				
Creditors + 25,000	12% Loan+ 100,000	Capital = 50,000	Cash + 150,000	Goods 25,000

Since the purchase of stock is the an acquisition of asset(revenue goods) it will not affect the income statement. Till the goods are sold, they will remain as assets in the balance sheet. Similarly, there will no effect on the cash flow statement as the purchase of goods on credit does not involve any cash flows
When the creditors are paid on the due date, creditors will be become zero and there will be corresponding decrease in cash.

Example 9.2
Table 9.5 shows the assets and the corresponding sources of ABC ltd.

Table 9.5			
Balance sheet of ABC ltd. as on 1st April 2006			
Sources		Assets	
Capital	50,000	Plant	50,000
12% Loan	80,000	Stock	80,000
Profit	70,000	Debtors	25000
Creditors	20,000	Cash	65000
	220,000		220,000

Transactions during the first quarter are as follows:
- Sold entire stock for 150,000 for cash.
- Paid full amount due to the creditors.
- Charged depreciation for the period = 1250.
- Expenses paid = 20,000

Tables 9.6 through 9.8 shows the income statement, cash flow statement and balance sheet. See the change in creditors. Creditors reduced during the period as the company paid off the opening creditors.

Table 9.6	
Income Statement	
Income	
Sales	150,000
Expenses	
COGS	80,000
Expenses	20,000
Depreciation	1,250
Interest	2,400
	103,650
Profit	46,350

Table 9.7	
Cash Flow Statement	
Opening Cash	65,000
Sales	150,000
	215,000
Expenses	20,000
Payment to Creditors	20,000
	40,000
Closing Cash	175,000

Table 9.8			
Balance sheet of ABC ltd. as on 1st April 2005			
Sources		Assets	
Capital	50,000	Plant	48,750
12% Loan	80,000	Stock	0
Profit	116,350	Debtors	25000
Creditors	0	Cash	175,000
Outstanding Interest	2,400		
	248,750		248,750

Bills Payable

Some time creditors are given negotiable instruments mentioning that they will be paid on the due date. Such documents are called bills payable. If the bills are issued in favour of the creditors, the name of the creditor will not appear on the balance sheet and the bills payables are shown as separate item of current liabilities.

Example 9.3
Table 9.9 shows the assets and the corresponding sources of ABC ltd. as on 1st April 2006.
If the company issues bills to some of the creditors, say, Rs.20,000. Table 9.10 shows the balance after the issue of bills payables to the creditors

Table 9.9	
Balance sheet of ABC ltd. as on 1st April 2006	
Sources	
Capital	100,000
12% Loan	50,000
Profit	50,000
Creditors	45,000
	245,000
Assets	
Plant	80,000
Stock	30,000
Debtors	65000
Cash	70,000
	245,000

Table 9.10	
Balance sheet of ABC ltd. as on 1st April 2006	
Sources	
Capital	100,000
12% Loan	50,000
Profit	50,000
Creditors	25,000
Bills Payable	20,000
	245,000
Assets	
Plant	80,000
Stock	30,000
Debtors	65000
Cash	70,000
	245,000

Outstanding Expenses

When a company incurs expenses: salary, rent etc. it has to make the necessary payment from the existing cash. Such payment can also be made by taking loans, raising capital or sometimes the company can also post pone those payments. Such expenses due but not paid are called outstanding expenses. The outstanding expenses are generally treated as short term liabilities.

Example 9.4
As on 1st April 2006 A ltd has assets worth of 120,000 funded by capital, long term liabilities, and profit in the ration of 3:2:1 as shown by the table 9.11

Transactions during the first quarter:

- Salary for the period due but not paid
- Interest due but not paid
- Depreciation on furniture = 1000
- No sales
- Purchased shares of XYltd =9,000

So during the first quarter the company did not receive any cash and 90% of the cash available was used for purchasing the shares of another company. So the expenses for the period remained as outstanding and will be shown as the short term liabilities. Table 9.12, 9.13, and 9.14 show the income statement for the quarter, cash flow statement for the quarter and balance sheet as at the end of the first quarter.

Table 9.11

Balance sheet of ABC ltd. as on 1st April 2006	
Sources	
Capital	40,000
12% Loan	60,000
Profit	20,000
	120,000
Assets	
Stock	80,000
Furniture	30000
Cash	10000
	120,000

Table 9.12

Income Statement for the quarter ending June 06	
Income	
Sales	0
Expenses	
COGS	0
Salary	6,000
Depreciation	1,000
Interest	1800
Profit	**-8,800**

Table 9.13

Cash Flow Statement for the quarter ending June 06	
Opening Cash	10000
Receipts	0
Payments	0
Salary	0
Shares	9000
Interest	0
Closing Cash	1000

Table 9.14

Balance sheet of ABC ltd. as on June 30 2006	
Sources	
Capital	40,000
12% Loan	60,000
Profit	11,200
Outstanding Salary	6000
Outstanding Interest	1800
	119,000
Assets	
Stock	80,000
Furniture	29,000
Shares	9,000
Cash	1000
	119,000

One can see the impact on the profit. Profit is reduced even if the expenses have not been paid. This can be attributed to the accrual concept of accounting. No change in the cash but there is a reduction of profit. When in later time period the outstanding expenses are paid, there will be a corresponding decrease in cash and the outstanding expense will no more appear as liabilities on the balance sheet.

Short Term Debt

Some times companies take short term loans to meet their immediate obligations and cover the temporary shortages in cash. Such loans are taken to meet operating expenses: salary, rent, electricity bills etc. Such loans carry relatively higher rate of interest. There are different types of short term debts. Table 9.15 shows the short term borrowings of some of the well know companies of India.

Table 9.15

Short Term Borrowings as % Current Liabilities(Rs. Crore) of NIFTY Companies (as on 31 Mar 06)

Hindustan Petroleum Corpn. Ltd.	4544.21	61%	Tata Steel Ltd.	56.49	2%
Reliance Industries Ltd.	4142.82	33%	Dabur India Ltd.	12.93	7%
Bharat Petroleum Corpn. Ltd.	4031.35	45%	Wipro Ltd.	44.89	3%
Bharti Airtel Ltd.	1842.46	28%	I T C Ltd.	26.04	1%
Reliance Energy Ltd.	1334.81	80%	A C C Ltd.	36.13	4%

CMIE Data base

Advance Incomes

If a company receives advance from the customer with a promise to deliver goods or services in future, such advance will not be treated as an income till the service or goods is provided to customer. Such advance is treated as a current liability. In case the company fails to honor its commitment it has to return the advance received.

Example 9.5

Let us continue with the example 9.4 and take the balance sheet as on 1st July 2006. Suppose the transactions during the month of July as follows:

- Received Advance from a customer for rendering services = Rs. 20,000
- Company will start providing the services from the Month of August 06.
- Used the cash to paid salary including the salary for the previous months.

Money received from the customer will not be treated as an income for the month of July. Money received will be treated as a receipt and shown on the balance sheet as a liability.

Tables 9.16 through 9.19 show the financial statements for the month of July

Table 9.16	
Balance sheet of ABC ltd. as on 1st July 2006	
Sources	
Capital	40,000
12% Loan	60,000
Profit	11,200
Outstanding Salary	6000
Outstanding Interest	1800
	119,000
Assets	
Stock	80,000
Furniture	29,000
Shares	9,000
Cash	1000
	119,000

Table 9.17	
Income Statement for the month ending July 31 2006	
Income	
Sales	0
Expenses	
COGS	0
Salary	2,000
Depreciation	300
Interest	600
Profit	-2,900

Table 9.18	
Cash Flow Statement for the month ending July 31 2006	
Opening Cash	1000
Receipts	
Advance	20000
Payments	0
Salary	8,000
Closing Cash	13,000

Table 9.19	
Balance sheet of ABC ltd. as on July 31 2006	
Sources	
Capital	40,000
12% Loan	60,000
Profit	8,300
Advance Income	20,000
Outstanding Salary	0
Outstanding Interest	2400
	130,700
Assets	
Stock	80,000
Furniture	28,700
Shares	9,000
Cash	13,000
	130,700

Provisions

According to the Companies Act 1956, the expression "provision" mean any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, or retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy. Table 9.20 shows the provisions as % of total sources of some of the well known companies of India.

Table 9.20					
Provisions as % of Total Sources(Rs. Crore) as on 31 Mar 06					
Oil & Natural Gas Corpn. Ltd.	31417.75	27%	Reliance Industries Ltd.	3890.98	4%
Steel Authority Of India Ltd.	7400.66	23%	Gujarat Ambuja Cements Ltd.	106.77	3%
G A I L (India) Ltd.	5549.37	25%	Dr. Reddy'S Laboratories Ltd.	85.14	2%
Mahanagar Telephone Nigam Ltd.	5163.24	24%	Zee Entertainment Enterprises Ltd.	53.56	2%
Dabur India Ltd.	113.89	14%	A B B Ltd.	51.2	2%
Bharat Heavy Electricals Ltd.	3711.42	18%	Reliance Communications Ltd.	2.57	0%

Source: CMIE Database

At this juncture, we will focus on the provisions for known liabilities rather than the provision for the decrease in assets.

Provision for Taxation

A company is required to provide for the taxes periodically. Such provisions are charged against the profits for the period.

Example 9.6

Following the sources and the corresponding assets of ABC ltd as on 1st April 2006

- Capital = 50,000; 12% Loan = 50,000; Stock of goods = 70,000;
- Cash = 30,000

During the first quarter the company had the following transaction.

- Sold all goods for 100,000 for cash
- Paid interest (for the quarter) on loan.
- Created a provision for taxation = 10,000

Table 9.20	
Balance sheet of ABC ltd. as on 1st July 2006	
Sources	
Capital	50,000
12% Loan	50,000
	100,000
Assets	
Stock	70,000
Cash	30,000
	100,000

Table 9.21	
Balance sheet of ABC ltd. as on 1st October 2006	
Sources	
Capital	40,000
12% Loan	60,000
Profit	18,500
Provision for Tax	10,000
	128,500
Assets	
Stock	0
Cash	128,500
	128,500

So provisions are reduced from the profit and shown as a separate item of liabilities. Provisions do not affect the cash flows. However, when the expenses (in this case, tax) are paid there will be a corresponding reduction in the cash.

Proposed Dividend

Distribution of profit as dividend is not an obligation. However, if a company declares dividend and does not disburse the amount among the shareholders, it will be treated as current liability. Table 9.22 shows the proposed as percentage of the current liabilities of some of the well known companies of India.

Table 9.22					
Proposed Dividend as % of Current Liabilities (Rs. Crore) as on 31 Mar 06					
Infosys Technologies Ltd.	1061	48%	H C L Technologies Ltd.	145.81	21%
Sun Pharmaceutical Inds. Ltd.	102.38	35%	National Aluminium Co. Ltd.	193.3	21%
I T C Ltd.	995.12	28%	Ambuja Cements Ltd.	81.11	20%
Satyam Computer Services Ltd.	186.85	26%	Ranbaxy Laboratories Ltd.	223.56	19%
Hero Honda Motors Ltd.	399.38	26%	Cipla Ltd.	155.46	17%
Wipro Ltd.	712.9	23%	Glaxosmithkline Pharmaceuticals Ltd.	237.17	15%

Source: CMIE Database