Financial Accounting

Liabilities

Meaning and Nature

In financial accounting, a **liability** is defined as an *obligation* of an entity arising from *past* transactions or events, the settlement of which may result in the transfer or use of assets, provision of services or other yielding of economic benefits in the future.

A liability represents a claim or right to be paid. It represents the debt of the business. Liabilities mean outside liabilities.

Overview

Liabilities have three essential characteristics:

- They embody a duty or responsibility to others that entails settlement by future transfer or use of assets, provision of services or other yielding of economic benefits, at a specified or determinable date, on occurrence of a specified event, or on demand;

- The duty or responsibility obligates the entity leaving it little or no discretion to avoid it; and,

- The transaction or event obligating the entity has already occurred.

Classification of Liabilities

- **Liabilities** are reported on a balance sheet and are usually divided into two categories:
- **Current liabilities** — these liabilities are reasonably expected to be liquidated within a year. They usually include payables such as wages, accounts, taxes, and accounts payables, unearned revenue when adjusting entries, portions of long-term bonds to be paid this year etc.
- **Long-term liabilities** — these liabilities are reasonably expected not to be liquidated within a year. They usually include issued long-term bonds, notes payables, long-term leases, pension obligations, and long-term product warranties.— In these liabilities a company has to pay after a fixed or long period For ex:- Long term bank loans up to 1yr or more than one 1yr.
- Liabilities of uncertain value or timing are called provisions

An Example

- Money deposited with a bank becomes a liability of the bank, because the bank has an obligation to pay the depositor the money deposited; usually on demand. (The money deposited is an asset for the depositor; but this asset will not be recorded by the bank because it is not the bank's asset)

- A debit increases an *asset*; and a credit decreases an *asset*. A debit decreases a *liability*; and credit increases a *liability*.

- When a bank receives a deposit it credits a liability account called "Deposits" and credits the depositor's bank account for the same amount (the bank's "Deposits" account is the sum of all of the amounts credited to all of its customer's individual bank accounts). A deposit received by a bank is credited because the bank's liability to its customer, the depositor, increases. When a bank informs its depositor that it has debited the depositor's bank account, it means that the depositor's bank account has been decreased by the amount debited.

Sample Balance Sheet

Balance Sheet of ABC Ltd. As on 31/12/06			
Liabilities	**Amount**	**Assests**	**Amount**
SHARE CAPITAL		**FIXED ASSETS**	
Authorised Capital		Goodwill	
Issued Capital		Building	
Subscribed Capital		Machinary	
Called-up Capital		Land	
RESERVES AND SURPLUS		**INVESTMENTS**	
Share premium			
Capital fund			
Capital Redemption Reserve		**CURRENT ASSETS**	
General Reserves		Debtors	
Sinking Fund		Bills receivable (B/R)	
		Cash	
LOANS		Bank	
Secured loans		Inventory	
Debentures			
Loans and advances			
(borrowings)		**Miscellanious expenditure**	
		Preliminary expenses	
Unsecured Loans		Discount on shares	
		Brokerage	
CURRENT LIABILTIES		Underwriting commission	
Creditors			
B/P			
Outstanding rent/salary etc			
PROVISIONS			
Provision for bad debts			
Provision for Leave Encashment			
	xxxxxx		xxxxx

Capital or Owner's equity

It is the amount that the owner has provided to the business. It represents the owner's interest or equity in the assets of a business.

Therefore capital = Assets -Liabilities

Preference Share capital: Part of the share capital of a company that ranks after secured creditors but before ordinary shareholders in the event of liquidation. Preference rights are defined in the articles of association of the relevant company but may relate to dividend, voting rights, or distribution of surplus assets.

Definitions

Authorized share capital

Maximum number of shares that a company can issue, as specified in the firm's articles of incorporation.

Issued Share Capital

The number of shares from the authorised share capital that have been sold to shareholders. The division of the issued share capital determines the respective voting power of the shareholders.

Subscribed Share Capital

It is that part of the share capital that has been subscribed by the public.

Definitions

Secured Loans: A secured **loan** is a loan in which the borrower pledges some asset (e.g. a car or property) as collateral for the loan, which then becomes a **secured debt** owed to the creditor who gives the loan. The debt is thus secured against the collateral — in the event that the borrower defaults, the creditor takes possession of the asset used as collateral and may sell it to satisfy the debt by regaining the amount originally lent to the borrower. From the creditor's perspective this is a category of debt in which a lender has been granted a portion of the bundle of rights to specified property. The opposite of secured debt/loan is unsecured debt, which is not connected to any specific piece of property and instead the creditor may satisfy the debt against the borrower rather than just the borrower's collateral.

Definitions

- **Debenture** is a long-term debt instrument used by governments and large companies to obtain funds. It is similar to a bond except the securitization conditions are different. A debenture is usually unsecured in the sense that there are no liens or pledges on specific assets. It is however, secured by all properties not otherwise pledged. In the case of bankruptcy debenture holders are considered general creditors.

- The advantage of debentures to the issuer is they leave specific assets unencumbered, and thereby leave them open for subsequent financing.

- Debentures are generally freely transferrable by the debenture holder.

Definitions

- Accrual in accounting as an abbreviation of terms **accrued expense** or **accrued revenue**. In accrual basis accounting, *accrued expense* is a liability resulting from an expense for which no invoice or other official document is available yet. Similarly, *accrued revenue* is an asset resulting from a revenue for which no official document was issued yet. The other side of the entry will always be a profit and loss account - expense in the first case and revenue in the latter one.

- In contrast to "Provision", the amount and occurrence for accruals is known.

Share Premium and its application

Where a company issues shares at a premium, a sum equal to the aggregate amount or value of the premiums on those shares shall be transferred to an account, to be called "the securities premium account";

The securities premium shall be applied in the following manner (Section 78 of Companies Act, 1956):

- Paying up unissued shares of the company to be issued to members of the company as fully paid bonus shares.
- Writing off the preliminary expenses of the company.
- Writing off the expenses of, or commission paid or discount allowed on, any issue of shares or debentures of the company.
- Providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company.

Thank you