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CHAPTER 13

Current Liabilities and Contingencies

ASSIGNMENT CLASSIFICATION TABLE (BY TOPIC)

Topics		Questions	Brief Exercises	Exercises	Problems	Concepts for Analysis
1.	Concept of liabilities; definition and classification of current liabilities.	1, 2, 3, 4, 6, 8		1, 5, 21	1, 2	1
2.	Accounts and notes payable; dividends payable.	7, 11	1, 2, 3	2	1, 2	1, 2
3.	Short-term obligations expected to be refinanced.	9, 10	4, 5	3, 4, 5		3
4.	Deposits and advance payments.	5, 12	6			2
5.	Compensated absences and bonuses.	13, 14, 15	9, 10	6, 7, 21		
6.	Collections for third parties.	16	7, 8	8, 9, 10, 21	3, 4	
7.	Provisions and contingent liabilities (General).	17, 18, 19, 20, 21, 23	11, 12	16, 19, 20, 21	10, 11, 13	4, 5, 6
8.	Warranties.	22, 24	14, 15	11, 12, 21, 20	5, 6, 7, 12, 14	6, 7
9.	Premiums and awards offered to customers.		16	13, 18, 21	8, 9, 12, 14	
10.	Self-insurance, litigation, claims, assessments, restructurings, and environmental liabilities.	25, 26, 27, 28, 29	11, 12, 13, 17, 18, 19	14, 15, 16, 17, 19	2, 10, 11, 13	5, 6
11.	Presentation and analysis.	30, 31, 32		22, 23, 24	9	3

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ASSIGNMENT CLASSIFICATION TABLE (BY LEARNING OBJECTIVE)

Learning Objectives	Brief Exercises	Exercises	Problems
1. Describe the nature, type, and valuation of current liabilities.	1, 2, 3, 4, 6, 7	1, 2, 8	1, 2
2. Explain the classification issues of short-term debt expected to be refinanced.	4, 5	3, 4, 5	
3. Identify types of employee-related liabilities.	8, 9, 10	6, 7, 9, 10	3, 4
4. Explain the accounting for different types of provisions.	11, 12, 13, 14, 15, 16, 17, 18, 19	11, 12, 13, 14, 15, 16, 17, 18, 19, 20	2, 5, 6, 7, 8, 9, 10, 11, 12, 13, 14
5. Identify the criteria used to account for and disclose contingent liabilities and assets.	11, 12	16	10, 11, 13
6. Indicate how to present and analyze liability-related information.		21, 22, 23, 24	9

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ASSIGNMENT CHARACTERISTICS TABLE

Item	Description	Level of Difficulty	Time (minutes)
E13-1	Statement of financial position classification.	Simple	10–15
E13-2	Accounts and notes payable.	Moderate	15–20
E13-3	Refinancing of short-term debt.	Simple	10–12
E13-4	Refinancing of short-term debt.	Simple	10–15
E13-5	Debt classifications	Simple	15-20
E13-6	Compensated absences.	Moderate	25–30
E13-7	Compensated absences.	Moderate	25–30
E13-8	Adjusting entry for sales tax.	Simple	5–7
E13-9	Payroll tax entries.	Simple	10–15
E13-10	Payroll tax entries.	Simple	15–20
E13-11	Warranties.	Simple	10–15
E13-12	Warranties.	Moderate	15–20
E13-13	Premium entries.	Simple	15–20
E13-14	Restructuring issues.	Simple	15–20
E13-15	Restructuring.	Simple	15–20
E13-16	Provision's and contingencies.	Moderate	20–30
E13-17	Environmental liability.	Moderate	25–30
E13-18	Premiums.	Moderate	20–30
E13-19	Provisions.	Moderate	20–30
E13-20	Provisions.	Moderate	20–30
E13-21	Financial statement impact of liability transactions.	Moderate	20–25
E13-22	Ratio computations and discussion.	Simple	10–15
E13-23	Ratio computations and analysis.	Simple	20–25
E13-25	Ratio computations and effect of transactions.	Moderate	15–25
P13-1	Current liability entries and adjustments.	Simple	25–30
P13-2	Liability entries and adjustments.	Simple	25–35
P13-3	Payroll tax entries.	Moderate	20–30
P13-4	Payroll tax entries.	Simple	20–25
P13-5	Warranties, accrual, and cash basis.	Simple	15–20
P13-6	Extended warranties.	Simple	10–20
P13-7	Warranties, accrual, and cash basis.	Moderate	25–35
P13-8	Premium entries.	Moderate	15–25
P13-9	Premium entries and financial statement presentation.	Moderate	30–45
P13-10	Litigation claim: entries and essay.	Simple	25–30

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Assignment Characteristics Table (Continued)

Item	Description	Level of Difficulty	Time (minutes)
P13-11	Contingencies: entries and essays.	Moderate	35–45
P13-12	Warranties and premiums.	Moderate	20–30
P13-13	Liability errors.	Moderate	25–35
P13-14	Warranty and coupon computation.	Moderate	20–25
CA13-1	Nature of liabilities.	Moderate	20–25
CA13-2	Current versus non-current classification.	Moderate	15–20
CA13-3	Refinancing of short-term debt.	Moderate	30–40
CA13-4	Contingencies.	Simple	15–20
CA13-5	Possible environmental liability.	Simple	15–20
CA13-6	Warranties and litigation provisions.	Simple	15–20
CA13-7	Warranties.	Moderate	20–25

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ANSWERS TO QUESTIONS

1. Current liabilities are obligations reasonably expected to be settled within its normal operating cycle or within twelve months after the reporting date. Non-current liabilities consist of all liabilities not properly classified as current liabilities.

2. You might explain to your friend that the IASB defines a liability as part of its conceptual framework. The formal definition of liabilities is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits. A liability has three essential characteristics: (1) it is a present obligation; (2) it arises from past events and (3) it results in an outflow of resources.

3. As a lender of money, the banker is interested in the priority his/her claim has on the company's assets relative to other claims. Close examination of the liability section and the related footnotes discloses amounts, maturity dates, collateral, subordinations, and restrictions of existing contractual obligations, all of which are important to potential creditors. The assets and earning power are likewise important to a banker considering a loan.

4. By definition, current liabilities are obligations reasonably expected to be settled within its normal operating cycle or within twelve months after the reporting date.

5. Unearned revenue is a liability that arises from current sales but for which some future services or products are owed to customers in the future. At the time of a sale, customers pay not only for the delivered product, but they also pay for future products or services (e.g., another plane trip, hotel room, or software upgrade). In this case, the company recognizes revenue from the current product and part of the sale proceeds is recorded as a liability (unearned revenue) for the value of future products or services that are "owed" to customers. Market analysts indicate that an increase in the unearned revenue liability, rather than raising a red flag, often provides a positive signal about sales and profitability. When the sales are growing, its unearned revenue account should grow. Thus, an **increase** in a liability may be good news about company performance. In contrast, when unearned revenues decline, the company owes less future amounts but this also means that sales of new products may have slowed.

6. Payables and receivables generally involve an interest element. Recognition of the interest element (the cost of money as a factor of time and risk) results in valuing future payments at their current value. The present value of a liability represents the debt exclusive of the interest factor.

7. A zero-interest-bearing note is initially recorded at the amount of cash received (or the present value of the note). The present value of the note equals the face value of the note at maturity less the interest charged by the lender for the term of the note. As time passes, interest is accrued as an increase to the note payable.

8. Liabilities that are due on demand (callable by the creditor) should be classified as a current liability. Classification of the debt as current is required because it is a reasonable expectation that existing working capital will be used to satisfy the debt. Liabilities often become callable by the creditor when there is a violation of the debt agreement. Only if the creditor agrees before the reporting date to provide a grace period that extends at least twelve months past the reporting date can the debt be classified as non-current.

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Questions Chapter 13 (Continued)

9. A company should exclude a short-term obligation from current liabilities only if (1) it intends to refinance the obligation on a long-term basis, and (2) it has an unconditional right to defer settlement of the liability for at least twelve months after the reporting date.

10. The ability to defer settlement of short-term debt may be demonstrated by entering into a financing agreement that clearly permits the company to refinance the debt on a long-term basis on terms that are readily determinable before the next reporting date.

11. A cash dividend formally authorized by the board of directors would be recorded by a debit to Retained Earnings and a credit to Dividends Payable. The Dividends Payable account should be classified as a current liability.

An accumulated but undeclared dividend on cumulative preference shares is not recorded in the accounts as a liability until declared by the board, but such arrearages should be disclosed either by a footnote to the statement of financial position or parenthetically in the share capital section.

A share dividend distributable, formally authorized and declared by the board, does not appear as a liability because a share dividend does not require future outlays of assets or services and is revocable by the board prior to issuance. Even so, an undistributed share dividend is generally reported in the equity section since it represents retained earnings in the process of transfer to share capital.

12. Unearned revenue arises when a company receives cash or other assets as payment from a customer before conveying (or even producing) the goods or performing the services which it has committed to the customer.

Unearned revenue is assumed to represent the obligation to the customer to refund the assets received in the case of nonperformance or to perform according to the agreement and thus earn the unrestricted right to the assets received. While there may be an element of unrealized profit included among the liabilities when unearned revenues are classified as such, it is ignored on the grounds that the amount of unrealized profit is uncertain and usually not material relative to the total obligation.

Unearned revenues arise from the following activities:
(1) The sale by a transportation company of tickets or tokens that may be exchanged or used to pay for future fares.
(2) The sale by a restaurant of meal tickets that may be exchanged or used to pay for future meals.
(3) The sale of gift certificates by a retail store.
(4) The sale of season tickets to sports or entertainment events.
(5) The sale of subscriptions to magazines.

13. Compensated absences are employee absences such as vacation, illness, maternity, paternity, and jury leaves for which it is expected that employees will be paid.

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14. A liability should be accrued for the cost of compensated absences if the employer has an obligation to make payment to an employee even after terminating his or her employment (vested rights) or if the employees can carry forward the rights to future periods if not used in the period in which earned (accumulated rights).

15. Vested rights with respect to compensated absences exist if the employer has an obligation to make payment to an employee even after terminating his or her employment. Accumulated rights are those that employees can carry forward to future periods if not used in the period in which earned. Non-accumulated rights do not carry forward, but lapse if not used within the period earned. Vested and accumulated rights are accrued by the employer as these are earned by the employee. Non-accumulated rights are recognized only when the absence commences.

16. Employers generally hold back from each employee's wages amounts to cover income taxes (withholding), the employee's share of social security taxes, and other items such as union dues or health insurance. In addition, the employer must set aside amounts to cover the employer's share of social security taxes. These latter amounts are recorded as payroll expenses and will lower Battle's income. In addition, the amount set aside (both the employee and the employer share) will be reported as current liabilities until they are remitted to the appropriate third party.

17. A provision is defined as a liability of uncertain timing or amount and is sometimes referred to as an estimated liability. Common types of provisions are obligations related to litigation, warranties, product guarantees, business restructurings, and environmental damage.

18. A provision should be recorded and a charge accrued to expense only if:

(a) the company has a present obligation (constructive or legal) as a result of a past event,
(b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, and
(c) a reliable estimate can be made of the amount of the obligation.

19. A current liability such as accounts payable is susceptible to precise measurement because the date of payment, the payee, and the amount of cash needed to discharge the obligation are reasonably certain. There is nothing uncertain about (1) the fact that the obligation has been incurred and (2) the amount of the obligation.

A provision is a liability of uncertain timing or amount and has greater uncertainty about the timing or amount of the future expenditure required to settle the obligation.

20. In determining whether a provision should be recognized, in addition to assessing whether a past event has occurred and a reliable estimate can be developed, a company must also assess whether the outflow of resources is probable. The term probable is defined as "more likely than not" to occur. This phrase is interpreted to mean the probability of occurrence is greater than 50 percent. If the probability is 50 percent or less, the provision is not recognized.

With respect to contingencies, Illustrations 13-12 and 13-14 summarize the general guidelines for the accounting and reporting of contingent liabilities and assets. As indicated there, virtually certain corresponds to a high probability of occurrence (at least 90%). Thus, a provision would be recorded under these circumstances. Contingent assets are not recognized on the statement of financial position unless realization of the contingent asset is virtually certain—that is, it is no longer considered a contingent asset and is recognized as an asset. Again, virtually certain is generally interpreted to be at least a probability of 90 percent or more. Disclosure related to a contingent asset is required when probable (more likely than not). No disclosure is required when the probability of inflow of economic benefits is less the 50%.

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21. A legal obligation generally results from a contract or legislation. A constructive obligation is an obligation derived from the company's actions where (a) by an established pattern of past practice, published policies, or a sufficiently specific current situation, the company has indicated to other parties that it will accept certain responsibilities; and (b) as a result, the company has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

22. Under the **cash-basis method,** warranty costs are charged to expense in the period in which the seller or manufacturer performs in compliance with the warranty. No liability is recorded for future costs arising from warranties, and the period of sale is not necessarily charged with the costs of making good on outstanding warranties. Under the **accrual method,** a provision for warranty costs is made at the time of sale or as the productive activity takes place; the accrual method may be applied two different ways: expense warranty versus sales warranty method. But under either method, the attempt is to recognize warranty expense in the year of sale.

23. Under IFRS, companies may not record provisions for future operating losses. Such provisions do not meet the definition of a liability, since the amount is not the result of a past transaction (the losses have not yet occurred). Therefore the liability has not been incurred. Furthermore, operating losses reflect general business risks for which a reasonable estimate of the loss could not be determined. Note that use of provisions in this way is one of the examples of earnings management discussed in Chapter 4. By reducing income in good years through the use of contingencies, companies can smooth out their income from year-to-year.

24. The expense warranty approach and the sales warranty approach are both variations of the accrual method of accounting for warranty costs. The expense warranty approach charges the estimated future warranty costs to operating expense in the year of sale or manufacture. The sales warranty approach defers a certain percentage of the original sales price until some future time when actual costs are incurred or the warranty expires.

25. Onerous contracts are ones in which the unavoidable costs of meeting the obligations exceed the economic benefits expected to be received. Examples include a loss to be recognized on an unfavorable non-cancellable purchase commitment for inventory, and a lease cancellation fee for a facility that is no longer being used.

26. A restructuring is a program that is planned and controlled by management and materially changes either (1) the scope of a business undertaken by the company; or (2) the manner in which the business is conducted. Costs that should not be included in a restructuring provision include investment in new systems, lower utilization of facilities, costs of training or relocating staff, costs of moving assets or operations, administration or marketing costs, allocation of corporate overhead, and expected future operating costs or expected operating losses unless they relate to an onerous contract.

27. An environmental provision must be recognized when a company has an existing legal obligation associated with the retirement of a long-lived asset and when the amount can be reasonably estimated.

28. The absence of insurance does not mean that a liability has been incurred at the date of the financial statements. Until the time that an event occurs there can be no diminution in the value of property or incurrence of a liability. If an event has occurred which exposes an enterprise to risks of injury to others and/or damage to the property of others, then a contingent liability exists. Expected future injury, damage, or loss resulting from lack of insurance need not be recorded or disclosed if no contingent liability exists. And, a contingent liability exists only if an uninsurable event which causes probable loss has occurred. Lack of insurance is not in itself a basis for recording a liability or loss.

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29. In determining whether or not to record a liability for pending litigation, the following factors must be considered:

(a) The time period in which the underlying cause for action occurred.
(b) The probability of an unfavorable outcome.
(c) The ability to make a reliable estimate of the amount of loss.

Before recording a liability for threatened litigation, the company must determine:

(a) The degree of probability that a suit may be filed or a claim or assessment may be asserted, and
(b) The probability of an unfavorable outcome.

If both are probable, the loss reliably estimable, and the cause for action dated on or before the date of the financial statements, the liability must be accrued.

30. There are several defensible recommendations for listing current liabilities: (1) in order of maturity, (2) in descending order of amount, (3) in order of liquidation preference. The authors' recent review of published financial statements disclosed that a significant majority of the published financial statements examined listed "notes payable" first, regardless of relative amount, followed most often by "accounts payable," and ending the current liability section with "current portion of long-term debt."

31. The acid-test ratio and the current ratio are both measures of the short-term debt-paying ability of the company. The acid-test ratio excludes inventories and prepaid expenses on the basis that these assets are difficult to liquidate in an emergency. The current ratio and the acid-test ratio are similar in that both numerators include cash, short-term investments, and net receivables, and both denominators include current liabilities.

32. (a) A liability for goods purchased on credit should be recorded when title passes to the purchaser. If the terms of purchase are f.o.b. destination, title passes when the goods purchased arrive; if f.o.b. shipping point, title passes when shipment is made by the vendor.

(b) A provision for an onerous contract is recorded when it is determined that the corporation is a party to a contract that is considered onerous and as a result has a present obligation, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, and a reliable estimate of the obligation can be made.

(c) A special bonus to employees should be recorded when approved by the board of directors or person having authority to approve, if the bonus is for a period of time and that period has ended at the date of approval.

(d) A provision for warranties should be recorded when it is probable that customers will make warranty claims and the corporation can reasonably estimate the costs involved.

(e) Profit-sharing payments are considered additional wages and the liability should be recorded in the year the profit-sharing relates to.

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SOLUTIONS TO BRIEF EXERCISES

BRIEF EXERCISE 13-1

Date	Account	Debit	Credit
July 1	Purchases	60,000	
	Accounts Payable		60,000
	Freight-in	1,200	
	Cash		1,200
July 3	Accounts Payable	6,000	
	Purchase Returns and Allowances		6,000
July 10	Accounts Payable	54,000	
	Cash ($54,000 X 98%)		52,920
	Purchase Discounts		1,080

BRIEF EXERCISE 13-2

Date	Account	Debit	Credit
11/1/10	Cash	40,000	
	Notes Payable		40,000
12/31/10	Interest Expense	600	
	Interest Payable ($40,000 X 9% X 2/12)		600
2/1/11	Notes Payable	40,000	
	Interest Payable	600	
	Interest Expense	300	
	Cash [($40,000 X 9% X 3/12) + $40,000]		40,900

BRIEF EXERCISE 13-3

Date	Account	Debit	Credit
11/1/10	Cash	60,000,000	
	Notes Payable		60,000,000
12/31/10	Interest Expense	900,000	
	Notes Payable (¥1,350,000 X 2/3)		900,000

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BRIEF EXERCISE 13-3 (Continued)

2/1/11	Interest Expense	450,000	
	Notes Payable		450,000
	Notes Payable	61,350,000	
	Cash		61,350,000

BRIEF EXERCISE 13-4

(a) While Burr has the intent to refinance, Burr did not have the unconditional right to defer payment as of December 31. The entire amount would be reported as current liability.

(b) While Burr has the intent to refinance, Burr did not have the unconditional right to defer payment as of December 31. The entire amount would be reported as current liability.

BRIEF EXERCISE 13-5

The debt becomes payable on demand because of the breach of a covenant and therefore should be reported as a current liability. The agreement with the lender to provide a waiver of the breach is after the financial reporting date and does not affect the classification of the debt obligation as of December 31.

BRIEF EXERCISE 13-6

8/1/10	Cash	216,000	
	Unearned Subscription Revenue (12,000 X $18)		216,000
12/31/10	Unearned Subscription Revenue	90,000	
	Subscription Revenue ($216,000 X 5/12 = $90,000)		90,000

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BRIEF EXERCISE 13-7

		Debit	Credit
(a)	Accounts Receivable	31,800	
	Sales		30,000
	Sales Taxes Payable ($30,000 X 6% = $1,800)		1,800
(b)	Cash	20,670	
	Sales ($20,670 ÷ 1.06 = $19,500)		19,500
	Sales Taxes Payable		1,170

BRIEF EXERCISE 13-8

	Debit	Credit
Wages Expense	24,000	
Social Security Taxes Payable		1,920
Withholding Taxes Payable		2,990
Insurance Premiums Payable		250
Cash		18,840

BRIEF EXERCISE 13-9

	Debit	Credit
Wages Expense	42,000	
Vacation Wages Payable (30 X 2 X $700)		42,000

BRIEF EXERCISE 13-10

		Debit	Credit
12/31/10	Bonus Expense	350,000	
	Bonus Payable		350,000
2/15/11	Bonus Payable	350,000	
	Cash		350,000

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BRIEF EXERCISE 13-11

(a) Lawsuit Loss 900,000
        Lawsuit Liability 900,000

(b) No entry is necessary. The loss is not accrued because it is not probable that a liability has been incurred at 12/31/10.

BRIEF EXERCISE 13-12

Buchanan should record a litigation accrual on the patent case, since the amount is both reliably estimable and probable. This entry will reduce income by $300,000 and Buchanan will report a litigation liability of $300,000. The $100,000 self-insurance allowance has no impact on income or liabilities.

BRIEF EXERCISE 13-13

	Debit	Credit
Oil Platform	450,000	
Environmental Liability		450,000

BRIEF EXERCISE 13-14

Date	Account	Debit	Credit
2010	Warranty Expense	70,000	
	Cash, Inventory, etc		70,000
12/31/10	Warranty Expense	400,000	
	Warranty Liability		400,000

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BRIEF EXERCISE 13-15

		Debit	Credit
(a)	Cash	1,980,000	
	Unearned Warranty Revenue (20,000 X $99)		1,980,000
(b)	Warranty Expense	180,000	
	Cash, Inventory, etc.		180,000
(c)	Unearned Warranty Revenue	330,000	
	Warranty Revenue ($1,980,000 X $180/$1,080*)		330,000

*$180,000 + $900,000

BRIEF EXERCISE 13-16

	Debit	Credit
Premium Expense	96,000	
Premiums Liability		96,000*

*UPC codes expected to be sent in (30% X 1,200,000)	360,000
UPC codes already redeemed	(120,000)
Estimated future redemptions	240,000
Cost of estimated claims outstanding (240,000 ÷ 3) X ($1.10 + $0.60 – $0.50)	$ 96,000

BRIEF EXERCISE 13-17

Cargo Company's lawsuit claim represents a contingent asset because the odds of winning the case are 75% (probable, but not virtually certain). Contingent assets are not recognized on the statement of financial position.

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BRIEF EXERCISE 13-18

Costs that should not be included in a restructuring provision include marketing costs to rebrand the company image and expected future losses for keeping the plant open for another year.

BRIEF EXERCISE 13-19

Loss on Lease Contract	**1,450,000**	
Lease Contract Liability		**1,450,000**

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SOLUTIONS TO EXERCISES

EXERCISE 13-1 (10–15 minutes)

(a) Current liability.
(b) Current liability.
(c) Current liability or non-current liability depending on term of warranty.
(d) Current liability.
(e) Footnote disclosure (assume possible not probable).
(f) Current liability.
(g) Current or non-current liability depending upon the time involved.
(h) Current liability.
(i) Current liability.
(j) Current liability.
(k) Current liability.
(l) Current liability.
(m) Current liability.
(n) Current liability.
(o) Footnote disclosure.
(p) Separate presentation in either current or non-current liability section.

EXERCISE 13-2 (15–20 minutes)

(a)	Sept. 1	Purchases	50,000	
		Accounts Payable		50,000
	Oct. 1	Accounts Payable	50,000	
		Notes Payable		50,000
	Oct. 1	Cash	75,000	
		Notes Payable		75,000
(b)	Dec. 31	Interest Expense	1,000	
		Interest Payable ($50,000 X 8% X 3/12)		1,000
	Dec. 31	Interest Expense	1,500	
		Notes Payable ($6,000 X 3/12)		1,500

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EXERCISE 13-2 (Continued)

(c)	1.	Note payable	$50,000
		Interest payable	1,000
			$51,000
	2.	Note payable ($75,000 + $1,500).....	$76,500

EXERCISE 13-3 (10–12 minutes)

ALEXANDER COMPANY
Partial Statement of Financial Position
December 31, 2010

Current liabilities:	
Notes payable (Note 1)..	€1,200,000

NOTE 1:

Short-term debt refinanced. As of December 31, 2010, the company had notes payable totaling €1,200,000 due on February 2, 2011. These notes were refinanced on their due date to the extent of €900,000 received from the issuance of ordinary shares on January 21, 2011. The balance of €300,000 was liquidated using current assets.

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EXERCISE 13-4 (10–15 minutes)

Short-term obligation A. While the maturity of the obligation was extended to March 1, 2013, the agreement was not reached with the lender until February 1, 2011. Since the agreement was not in place as of the reporting date (December 31, 2010), the obligation should be reported as a current liability.

Short-term obligation B. The maturity of the obligation was extended to February 1, 2012 and the agreement with the lender was signed on December 18, 2010. Since the agreement was in place as of the reporting date (December 31, 2010), the obligation is reported as a non-current liability.

EXERCISE 13-5 (15–20 minutes)

(1) Debt that is callable on demand by the lender at any time should be classified as a current liability. The callable on demand feature overrides the stated maturity of December 31, 2013.

(2) When there is a breach of a debt covenant, the debt is normally classified as a current liability. However, if the company is able to obtain a period of grace from the lender prior to the reporting date as Mckee did (the agreement was reached on December 8, 2010), the debt should be classified as non-current.

(3) Mckee should classify $100,000 of the obligation as a current maturity of long-term debt (current liability) and the $300,000 balance as a non-current liability.

(4) While the maturity of the obligation was extended to February 15, 2013, the agreement was not reached with the lender until January 15, 2011. Since the agreement was not in place as of the reporting date (December 31, 2010), the obligation should be reported as a current liability.

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EXERCISE 13-6 (25–30 minutes)

(a) **2010**

To accrue expense and liability for compensated absences

Wages Expense	13,824	
Vacation Wages Payable		8,640 (1)
Sick Pay Wages Payable		5,184 (2)

To record payment for compensated time when used by employees

Sick Pay Wages Payable	3,456 (3)	
Cash		3,456

2011

To accrue expense and liability for compensated absences

Wages Expense	14,976	
Vacation Wages Payable		9,360 (4)
Sick Pay Wages Payable		5,616 (5)

To record payment for compensated time when used by employers

Wages Expense	792	
Vacation Wages Payable	7,776 (6)	
Sick Pay Wages Payable	4,536 (7)	
Cash		13,104 (8)

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EXERCISE 13-6 (Continued)

(1) 9 employees X $12.00/hr. X 8 hrs./day X 10 days = $8,640
(2) 9 employees X $12.00/hr. X 8 hrs./day X 6 days = $5,184
(3) 9 employees X $12.00/hr. X 8 hrs./day X 4 days = $3,456
(4) 9 employees X $13.00/hr. X 8 hrs./day X 10 days = $9,360
(5) 9 employees X $13.00/hr. X 8 hrs./day X 6 days = $5,616
(6) 9 employees X $12.00/hr. X 8 hrs./day X 9 days = $7,776
(7) 9 employees X $12.00/hr. X 8 hrs./day X (6–4) days = $1,728
9 employees X $13.00/hr. X 8 hrs./day X (5–2) days = +2,808 = $4,536
(8) 9 employees X $13.00/hr. X 8 hrs./day X 9 days = $8,424
9 employees X $13.00/hr. X 8 hrs./day X 5 days = +4,680 = $13,104

NOTE: Vacation days and sick days are paid at the employee's current wage. Also, if employees earn vacation pay at different pay rates, a consistent pattern of recognition (e.g., first-in, first-out) could be employed to recognize liabilities that have been paid.

(b) Accrued liability at year-end:

	2010		2011	
	Vacation Wages Payable	Sick Pay Wages Payable	Vacation Wages Payable	Sick Pay Wages Payable
Jan. 1 balance	$ 0	$ 0	$ 8,640	$1,728
+ accrued	8,640	5,184	9,360	5,616
– paid	(0)	(3,456)	(7,776)	(4,536)
Dec. 31 balance	$8,640(1)	$1,728(2)	$10,224(3)	$2,808(4)

(1) 9 employees X $12.00/hr. X 8 hrs./day X 10 days = $ 8,640

(2) 9 employees X $12.00/hr. X 8 hrs./day X (6–4) days = $ 1,728

(3) 9 employees X $12.00/hr. X 8 hrs./day X (10–9) days = $ 864
9 employees X $13.00/hr. X 8 hrs./day X 10 days = +9,360
$10,224

(4) 9 employees X $13.00/hr. X 8 hrs./day X (6 + 6 – 4 – 5) days $ 2,808

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EXERCISE 13-7 (25–30 minutes)

(a) **2010**

To accrue the expense and liability for vacations

Wages Expense	9,288 (1)	
Vacation Wages Payable		9,288

To record sick leave paid

Wages Expense	3,456 (2)	
Cash		3,456

To record vacation time paid
No entry, since no vacation days were used.

2011

To accrue the expense and liability for vacations

Wages Expense	9,864 (3)	
Vacation Wages Payable		9,864

To record sick leave paid

Wages Expense	4,680 (4)	
Cash		4,680

To record vacation time paid

Wages Expense	65	
Vacation Wages Payable	8,359 (5)	
Cash		8,424 (6)

(1) 9 employees X $12.90/hr. X 8 hrs./day X 10 days = $9,288

(2) 9 employees X $12.00/hr. X 8 hrs./day X 4 days = $3,456

(3) 9 employees X $13.70/hr. X 8 hrs./day X 10 days = $9,864

(4) 9 employees X $13.00/hr. X 8 hrs./day X 5 days = $4,680

(5) 9 employees X $12.90/hr. X 8 hrs./day X 9 days = $8,359

(6) 9 employees X $13.00/hr. X 8 hrs./day X 9 days = $8,424

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EXERCISE 13-7 (Continued)

(b) Accrued liability at year-end:

	2010	2011
Jan. 1 balance	$ 0	$ 9,288
+ accrued	9,288	9,864
– paid	(0)	(8,359)
Dec. 31 balance	$9,288(1)	$10,793(2)

(1) 9 employees X $12.90/hr. X 8 hrs./day X 10 days....... $ 9,288

(2) 9 employees X $12.90/hr. X 8 hrs./day X 1 day .... $ 929
9 employees X $13.70/hr. X 8 hrs./day X 10 days....... 9,864
$10,793

EXERCISE 13-8 (5–7 minutes)

June 30		
Sales	23,700	
Sales Tax Payable..		23,700

Computation:
Sales plus sales tax ($265,000 + $153,700)...................................... $418,700
Sales exclusive of tax ($418,700 ÷ 1.06) .... (395,000)
Sales tax .... $ 23,700

EXERCISE 13-9 (10–15 minutes)

Wages and Salaries Expense	340,000	
Withholding Taxes Payable..		80,000
Social Security Taxes Payable*		27,200
Union Dues Payable..		9,000
Cash		223,800

*[340,000 X 8% = $27,200]

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EXERCISE 13-9 (Continued)

Payroll Tax Expense	27,200	
Social Security Taxes Payable		27,200
(See previous computation.)		

EXERCISE 13-10 (15–20 minutes)

(a) Computation of taxes

	Factory	
Wages	$140,000	
Social security taxes	11,200	(8% X $140,000)
Total Cost	$151,200	

	Sales	
Wages	$32,000	
Social security taxes	2,560	(8% X 32,000)
Total Cost	$34,560	

	Administrative	
Wages	$36,000	
Social security taxes	2,880	(8% X $36,000)
Total Cost	$38,880	

Schedule

	Total	Factory	Sales	Administrative
Wages	$208,000	$140,000	$32,000	$36,000
Social Security	16,640	11,200	2,560	2,880
Total Cost	$224,640	$151,200	$34,560	$38,880

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EXERCISE 13-10 (Continued)

(b)

Factory Payroll:

Account	Debit	Credit
Wages and Salaries Expense	140,000	
Withholding Taxes Payable		16,000
Social Security Taxes Payable		11,200
Cash		112,800
Payroll Tax Expense	11,200	
Social Security Taxes Payable		11,200

Sales Payroll:

Account	Debit	Credit
Wages and Salaries Expense	32,000	
Withholding Taxes Payable		7,000
Social Security Taxes Payable		2,560
Cash		22,440
Payroll Tax Expense	2,560	
Social Security Taxes Payable		2,560

Administrative Payroll:

Account	Debit	Credit
Wages and Salaries Expense	36,000	
Withholding Taxes Payable		6,000
Taxes Payable		2,880
Cash		27,120
Payroll Tax Expense	2,880	
Social Security Taxes Payable		2,880

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EXERCISE 13-11 (10–15 minutes)

	Account	Debit	Credit
(a)	Cash (150 X £4,000)	600,000	
	Sales		600,000
	Warranty Expense	17,000	
	Cash, Inventory, Accrued Payroll		17,000
	Warranty Expense (£45,000* – £17,000)	28,000	
	Warranty Liability		28,000
	*(150 X £300)		
(b)	Cash	600,000	
	Sales		600,000
	Warranty Expense	17,000	
	Cash, Inventory, Accrued Payroll		17,000

EXERCISE 13-12 (15–20 minutes)

	Account	Debit	Credit
(a)	Cash	3,000,000	
	Sales (500 X $6,000)		3,000,000
	Warranty Expense	30,000	
	Cash, Inventory, Accrued Payroll		30,000
	Warranty Expense	90,000	
	Warranty Liability ($120,000 – $30,000)		90,000
(b)	Cash	3,000,000	
	Sales		2,840,000
	Unearned Warranty Revenue		160,000
	Warranty Expense	30,000	
	Cash, Inventory, Accrued Payroll		30,000
	Unearned Warranty Revenue	40,000	
	Warranty Revenue [$160,000 X ($30,000/$120,000)]		40,000

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EXERCISE 13-13 (15–20 minutes)

Inventory of Premiums (8,800 X €.90)	7,920	
Cash		7,920
Cash (120,000 X €3.30)	396,000	
Sales		396,000
Premium Expense	3,960	
Inventory of Premiums [(44,000 ÷ 10) X €.90]		3,960
Premium Expense	2,520*	
Liability for Premiums		2,520

*[(120,000 X 60%) – 44,000] ÷ 10 X €.90 = €2,520

EXERCISE 13-14 (15–20 minutes)

(1) Lease termination penalties are included. The ¥400,000 penalty to break the lease should therefore be included.

(2) Allocations of overhead are excluded.

(3) Costs of training staff are excluded.

(4) Use of an outplacement firm to assist with the terminations are employee termination costs directly related to the restructuring and should be included.

(5) Termination costs directly related to the restructuring are included.

(6) Costs of moving assets to other divisions are excluded.

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EXERCISE 13-15 (15–20 minutes)

(a) A restructuring is a program that is planned and controlled by management and materially changes either (1) the scope of a business undertaken by the company; or (2) the manner in which that business is conducted.

Examples include sale of a line of business, eliminating a layer of management, and closure of operation in a country.

(b) The two provisions are (1) management must have detailed formal plan for the restructuring; and (2) raise a valid expectation to those affected by implementation or announcement of the plan.

(c) Dolman may include the following costs as part of the restructuring provision: employee termination costs related to closing the division; and onerous contract provisions related to the closing.

EXERCISE 13-16 (20–30 minutes)

(1) The IASB requires that, when some amount within the range of expected loss appears at the time to be a better estimate than any other amount within the range, that amount is accrued. When no amount within the range is a better estimate than any other amount, the expected value (midpoint of the range) should be used. In this case, therefore, Maverick Inc. would report a liability of $1,100,000 at December 31, 2010.

(2) The loss should be accrued for $6,000,000. The potential insurance recovery is a contingent asset—it is not recorded until received. According to IFRS, claims for recoveries may only be recorded if the recovery is deemed virtually certain.

(3) This is a contingent asset because the amount to be received will be in excess of the book value of the plant. Contingent assets are not recorded and are disclosed only when the probabilities are high that a contingent asset will become reality.

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EXERCISE 13-17 (25–30 minutes)

	Account	Debit	Credit
(a)	Depot	600,000	
	Cash		600,000
	Depot	39,087	
	Environmental Liability		39,087
(b)	Depreciation Expense	60,000	
	Accumulated Depreciation		60,000
	Depreciation Expense	3,909	
	Accumulated Depreciation		3,909*
	Interest Expense	2,345	
	Environmental Liability		2,345**

*$39,087/10
**$39,087 X .06

	Account	Debit	Credit
(c)	Environmental Liability	70,000	
	Loss on Settlement of Environmental Liability	10,000	
	Cash		80,000

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EXERCISE 13-18 (20–30 minutes)

1.	Liability for stamp redemptions, 12/31/09	$13,000,000
	Cost of redemptions redeemed in 2010	(6,000,000)
		7,000,000
	Cost of redemptions to be redeemed in 2011 (5,200,000 X 80%)	4,160,000
	Liability for stamp redemptions, 12/31/10	$11,160,000
2.	Total coupons issued	$850,000
	Redemption rate	X 60%
	To be redeemed	510,000
	Handling charges ($510,000 X 10%)	51,000
	Total cost	$561,000
	Total cost	$561,000
	Total payments to retailers	(330,000)
	Liability for unredeemed coupons	$231,000
3.	Boxes	600,000
	Redemption rate	X 70%
	Total redeemable	420,000
	Coupons to be redeemed (420,000 – 250,000)	170,000
	Cost ($6.50 – $4.00)	X $2.50
	Liability for unredeemed coupons	$425,000

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EXERCISE 13-19 (20–30 minutes)

(1) The present value of the major overhaul payments ($3,200,000) should be included as part of the cost of the ship. The ship should be recorded at $23,200,000.

Ship	23,200,000	
Cash		20,000,000
Environmental Liability		3,200,000
Depreciation Expense	580,000	
Accumulated Depreciation		580,000

Note: Braegger would also accrue interest at the effective rate on the Environmental Liability.

(2) The lease is considered an onerous contract because the unavoidable costs of meeting the obligations under the lease exceed the benefits (facilities will no longer be used). The expected costs to satisfy the onerous contract (the $62,000 penalty for non-payment) are accrued.

Loss on Lease Contract	62,000	
Lease Contract Liability		62,000

(3) The company should recognize the costs associated with dismantling the plant upon building the plant as it has a legal obligation associated with its retirement.

Nuclear Power Plant	40,000,000	
Cash		40,000,000
Nuclear Power Plant	1,000,000	
Environmental Liability		1,000,000

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EXERCISE 13-20 (20–30 minutes)

(1)	Warranty Expense*	5,000,000	
	Warranty Liability		5,000,000

*Expected warranty costs

	%	Units	Cost per Unit	Total Costs
No defects	60%	600,000	$ 0	$ 0
Major defects	30%	300,000	15	4,500,000
Minor defects	10%	100,000	5	500,000
Total	100%	1,000,000		5,000,000

(2)	Tax Expense	400,000	
	Taxes Payable		400,000
(3)	Sales Returns*	5,600,000	
	Cash		5,600,000

*$80,000,000 x (5% + 9%)/2

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EXERCISE 13-21 (20–25 minutes)

#	Assets	Liabilities	Equity	Net Income
1.	I	I	NE	NE
2.	NE	NE	NE	NE
3.	NE	I	D	D
4.	I	I	NE	NE
5.	NE	I	D	D
6.	I	I	I	I
7.	D	I	D	D
8.	NE	I	D	D
9.	NE	I	D	D
10.	I	I	NE	NE
11.	NE	I	D	D
12.	I	I	I	I
13.	NE	I	D	D
14.	D	D	NE	NE
15.	NE	I	D	D
16.	D	NE	D	D
17.	NE	D	I	I
18.	NE	I	D	D

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EXERCISE 13-22 (10–15 minutes)

(a) $$\text{Current ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\$210{,}000}{\$70{,}000} = 3.00$$

Current ratio measures the short-term ability of the company to meet its currently maturing obligations.

(b) $$\text{Acid-test ratio} = \frac{\text{Cash + Short-term Investments + Net Receivables}}{\text{Current Liabilities}} = \frac{\$115{,}000}{\$70{,}000} = 1.64$$

Acid-test ratio also measures the short-term ability of the company to meet its currently maturing obligations. However, it eliminates assets that might be slow moving, such as inventories and prepaid expenses.

(c) $$\text{Debt to total assets} = \frac{\text{Total Liabilities}}{\text{Total Assets}} = \frac{\$210{,}000}{\$430{,}000} = 48.84\%$$

This ratio provides the creditors with some idea of the corporation's ability to withstand losses without impairing the interests of creditors.

(d) $$\text{Rate of return on assets} = \frac{\text{Net Income}}{\text{Average Total Assets}} = \frac{\$25{,}000}{\$430{,}000} = 5.81\%$$

This ratio measures the return the company is earning on its average total assets and provides one indication related to the profitability of the enterprise.

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EXERCISE 13-23 (20–25 minutes)

(a) (1) Current ratio = $\frac{¥733,000}{¥240,000}$ = 3.05

(2) Acid-test ratio = $\frac{¥52,000 + ¥158,000 + ¥80,000}{¥240,000}$ = 1.21

(3) Accounts receivable turnover =
¥1,640,000 ÷ $\frac{¥80,000 + ¥158,000}{2}$ = 13.8 times (or approximately every 26 days)

(4) Inventory turnover =
¥800,000 ÷ $\frac{¥360,000 + ¥440,000}{2}$ = 2 times (or approximately every 183 days)

(5) Rate of return on assets =
¥320,000 ÷ $\frac{¥1,400,000 + ¥1,630,000}{2}$ = 21.12%

(6) Profit margin on sales =
¥320,000 ÷ ¥1,640,000 = 19.51%

(b) Financial ratios should be evaluated in terms of industry peculiarities and prevailing business conditions. Although industry and general business conditions are unknown in this case, the company appears to have a relatively strong current position. The main concern from a short-term perspective is the apparently low inventory turnover. The rate of return on assets and profit margin on sales are extremely good and indicate that the company is employing its assets advantageously.

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EXERCISE 13-24 (15–25 minutes)

(a) (1) €318,000 ÷ €87,000 = 3.66 times

(2) €820,000 ÷ $\frac{€200,000 + €170,000}{2}$ = 4.43 times (or approximately 82 days).

(3) €1,400,000 ÷ $95,000 = 14.74 times (or approximately 25 days).

(4) €210,000 ÷ 52,000 (€260,000 ÷ €5) = $4.04

(5) €210,000 ÷ $1,400,000 = 15.0%

(6) €210,000 ÷ $488,000 = 43.03%

(b) (1) No effect on current ratio, if already included in the allowance for doubtful accounts.

(2) Weaken current ratio by reducing current assets.

(3) Improve current ratio by reducing current assets and current liabilities by a like amount.

(4) No effect on current ratio.

(5) Weaken current ratio by increasing current liabilities.

(6) No effect on current ratio.

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TIME AND PURPOSE OF PROBLEMS

Problem 13-1 (Time 25–30 minutes)
Purpose—to present the student with an opportunity to prepare journal entries for a variety of situations related to liabilities. The situations presented are basic ones including purchases and payments on account, and borrowing funds by giving a zero-interest-bearing note. The student is also required to prepare year-end adjusting entries.

Problem 13-2 (Time 25–35 minutes)
Purpose—to present the student with the opportunity to prepare journal entries for several different situations related to liabilities. The situations presented include accruals and payments related to sales, use, and environmental liabilties. Year-end adjusting entries are also required.

Problem 13-3 (Time 20–30 minutes)
Purpose—to present the student with an opportunity to prepare journal entries for four weekly payrolls. The student must compute income tax to be withheld, and social security tax.

Problem 13-4 (Time 20–25 minutes)
Purpose—to provide the student with the opportunity to prepare journal entries for a monthly payroll. The student must compute income tax to be withheld, and social security tax.

Problem 13-5 (Time 15–20 minutes)
Purpose—to provide the student with an opportunity to prepare journal entries and statement of financial position presentations for warranty costs under the cash-basis and the expense warranty accrual methods. Entries in the sales year and one subsequent year are required. The problem highlights the differences between the two methods in the accounts and on the statement of financial position.

Problem 13-6 (Time 10–20 minutes)
Purpose—to provide the student with a basic problem covering the sales-warranty method. The student is required to prepare journal entries in the year of sale and in subsequent years when warranty costs are incurred. Also required are statement of financial position presentations for the year of sale and one subsequent year. While the problem is basic in nature it does test the student's ability to understand and apply the sales warranty method.

Problem 13-7 (Time 25–35 minutes)
Purpose—to provide the student with an opportunity to prepare journal entries for warranty costs under the expense warranty method and the cash-basis method. The student is also required to indicate the proper statement of financial position disclosures under each method for the year of sale. Finally, the student is required to comment on the effect on net income of applying each method. The problem highlights the differences between the two methods in the accounts and on the statement of financial position.

Problem 13-8 (Time 15–25 minutes)
Purpose—to provide the student with a basic problem in accounting for premium offers. The student is required to prepare journal entries relating to sales, the purchase of the premium inventory, and the redemption of coupons. The student must also prepare the year-end adjusting entry reflecting the estimated liability for premium claims outstanding. A very basic problem.

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Time and Purpose of Problems (Continued)

Problem 13-9 (Time 30–45 minutes)
Purpose—to present the student with a slightly complicated problem related to accounting for premium offers. The problem is more complicated in that coupons redeemed are accompanied by cash payments, and in addition to the cost of the premium item postage costs are also incurred. The student is required to prepare journal entries for various transactions including sales, purchase of the premium inventory, and redemption of coupons for two years. The second year's entries are more complicated due to the existence of the liability for claims outstanding. Finally the student is required to indicate the amounts related to the premium offer that would be included in the financial statements for each of two years. This very realistic problem challenges the student's ability to account for all transactions related to premium offers.

Problem 13-10 (Time 25–30 minutes)
Purpose—to present the student with the problem of determining the proper amount of and disclosure for a contingent liability due to lawsuits. The student is required to prepare a journal entry and a footnote. The student is also required to discuss any liability incurred by a company due to the risk of loss from lack of insurance coverage. A straightforward problem dealing with contingent liabilities.

Problem 13-11 (Time 35–45 minutes)
Purpose—to provide the student with a comprehensive problem dealing with contingent liabilities. The student is required to prepare journal entries for each of three independent situations. For each situation the student must also discuss the appropriate disclosure in the financial statements. The situations presented include a lawsuit, an expropriation, and a self-insurance situation. This problem challenges the student not only to apply the guidelines set forth in **IFRS,** but also to develop reasoning as to how the guidelines relate to each situation.

Problem 13-12 (Time 20–30 minutes)
Purpose—to provide the student with a problem to calculate warranty expense, warranty liability, premium expense, inventory of premiums, and estimated premium? liability.

Problem 13-13 (Time 25–35 minutes)
Purpose—to present the student with a comprehensive problem in determining various liabilities and present findings in writing. Issues addressed relate to contingencies, warranties, and litigation.

Problem 13-14 (Time 20–25 minutes)
Purpose—to present the student with a comprehensive problem in determining the amounts of various liabilities. The student must calculate (for independent situations) the estimated liability for warranties, and an estimated liability for premium claims outstanding. Journal entries are not required. This problem should challenge the better students.

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SOLUTIONS TO PROBLEMS

PROBLEM 13-1

(a)

	Debit	Credit
February 2		
Purchases ($70,000 X 98%)	68,600	
Accounts Payable		68,600
February 26		
Accounts Payable	68,600	
Purchase Discounts Lost	1,400	
Cash		70,000
April 1		
Trucks	50,000	
Cash		4,000
Notes Payable		46,000
August 1		
Retained Earnings (Dividends Declared)	300,000	
Dividends Payable		300,000
September 10		
Dividends Payable	300,000	
Cash		300,000

(b) **December 31**

1. No adjustment necessary

	Debit	Credit
2. Interest Expense ($46,000 X 12% X 9/12)	4,140	
Interest Payable		4,140

3. No adjustment necessary

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PROBLEM 13-2

1.	Dec. 5	Cash	500	
		Returnable Deposit (Liability)		500
2.	Dec. 1-31	Cash	798,000	
		Sales ($798,000 ÷ 1.05)		760,000
		Sales Taxes Payable ($760,000 X .05)		38,000
3.	Dec. 10	Trucks ($120,000 X 1.05)	126,000	
		Cash		126,000
4.	Dec. 31	Parking Lot	84,000	
		Environmental Liability		84,000

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PROBLEM 13-3

Entries for Payroll 1

Account	Debit	Credit
Wages and Salaries Expense	1,040.00*	
Withholding Taxes Payable (10% X $1,040)*		104.00
Social Security Taxes Payable (8% X $1,040)		83.20
Union Dues Payable (2% X $1,040)		20.80
Cash		832.00

*$200 + $150 + $110 + $250 + $330 = $1,040

Account	Debit	Credit
Payroll Tax Expense	83.20	
Social Security Taxes Payable (8% X $1,040)		83.20

Entries for Payroll 2 and 3

Account	Debit	Credit
Vacation Wages Payable	590.00*	
Wages and Salaries Expense	450.00	
Withholding Taxes Payable (10% X $1,040)		104.00
Social Security Taxes Payable (8% X $1,040)		83.20
Union Dues Payable (2% X $1,040)		20.80
Cash		832.00

*($300 + $220 + $660) ÷ 2

Account	Debit	Credit
Payroll Tax Expense	83.20	
Social Security Taxes Payable (8% X $1,040)		83.20

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PROBLEM 13-3 (Continued)

Entries for Payroll 4

Account	Debit	Credit
Wages and Salaries Expense	1,040.00	
Withholding Taxes Payable (10% X $1,040)		104.00
Social Security Taxes Payable (8% X $1,040)		83.20
Union Dues Payable (2% X $1,040)		20.80
Cash		832.00
Payroll Tax Expense	83.20	
Social Security Taxes Payable (8% X $1,040)		83.20

Monthly Payment of Payroll Liabilities

Account	Debit	Credit
Withholding Taxes Payable ($104.00 X 4)	416.00	
Social Security Taxes Payable ($83.20 X 8)	665.60	
Union Dues Payable ($20.80 X 4)	83.20	
Cash		1,164.80

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PROBLEM 13-4

(a)

Name	Earnings to Aug. 31	September Earnings	Income Tax Withholding	Social Security
B. D. Williams	$ 6,800	$ 800	$ 80	$ 64
D. Raye	6,500	700	70	56
K. Baker	7,600	1,100	110	88
F. Lopez	13,600	1,900	190	152
A. Daniels	105,000	13,000	1,300	1,040
B. Kingston	112,000	16,000	1,600	1,280
Total	$251,500	$33,500	$3,350	$2,680

[a]$13,000 X 1.45% = $188.50
[b]$16,000 X 1.45% = $232.00

	Debit	Credit
Wages and Salaries Expense	33,500.00	
Withholding Taxes Payable		3,350.00
Social Security Taxes Payable		2,680.00
Cash		27,470.00

(b)

	Debit	Credit
Payroll Tax Expense	2,680.00	
Social Security Taxes Payable		2,680.00

(c)

	Debit	Credit
Withholding Taxes Payable	3,350.00	
Social Security Taxes Payable	5,360	
Cash		8,710

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PROBLEM 13-5

(a)	Cash (400 X £2,500)	1,000,000	
	Sales		1,000,000
(b)	Cash (400 X £2,500)	1,000,000	
	Sales		1,000,000
	Warranty Expense (400 X [£155 + £185])	136,000	
	Warranty Liability		136,000

(c) No liability would be disclosed under the cash-basis method relative to future costs due to warranties on past sales.

(d)	Current Liabilities:		
	Warranty Liability		£68,000
	Long-term Liabilities:		
	Warranty Liability		£68,000
(e)	Warranty Expense	61,300	
	Parts Inventory		21,400
	Accrued Payroll		39,900
(f)	Warranty Liability	61,300	
	Parts Inventory		21,400
	Accrued Payroll		39,900

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PROBLEM 13-6

		Debit	Credit
(a)	Cash	294,300	
	Sales (300 X $900)		270,000
	Unearned Warranty Revenue (270 X $90)		24,300

(b) **Current Liabilities:**

Unearned Warranty Revenue ($24,300/3)	$ 8,100

(Note: Warranty costs assumed to be incurred equally over the three-year period)

Non-current Liabilities:

Unearned Warranty Revenue ($24,300 X 2/3)	$16,200

		Debit	Credit
(c)	Unearned Warranty Revenue	8,100	
	Warranty Revenue		8,100
	Warranty Expense	6,000	
	Parts Inventory		2,000
	Accrued Payroll		4,000

(d) **Current Liabilities:**

Unearned Warranty Revenue	$ 8,100

Non-current Liabilities:

Unearned Warranty Revenue	$ 8,100

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PROBLEM 13-7

			Debit	Credit
(a)	(1)	Cash or Accounts Receivable	4,440,000	
		Sales (600 X $7,400)		4,440,000
	(2)	Warranty Expense	117,000	
		Parts Inventory ($170 X 600 X 1/2)		51,000
		Accrued Payroll ($220 X 600 X 1/2)		66,000
		($117,000 = $\frac{600 \text{ X } \$390}{2}$)		
	(3)	Warranty Expense	117,000	
		Warranty Liability (600 machines X $390) – $117,000		117,000
	(4)	Warranty Liability	117,000	
		Parts Inventory		51,000
		Accrued Payroll		66,000
(b)	(1)	Cash	4,440,000	
		Sales		4,440,000
	(2)	Warranty Expense	117,000	
		Parts Inventory		51,000
		Accrued Payroll		66,000

(3) Under the cash-basis method, the total warranty expense is recorded through entries 2 and 4 which recognize warranty costs as incurred. Warranty expense for 2011 is $117,000 under the cash basis.

		Debit	Credit
(4)	Warranty Expense	117,000	
	Parts Inventory		51,000
	Accrued Payroll		66,000

(c) Cash-basis method:

No liability for future costs to be incurred under outstanding warranties is recorded or normally disclosed under the cash basis method.

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PROBLEM 13-7 (Continued)

Expense warranty accrual method:

As of 12/31/10 the statement of financial condition would disclose a current liability in the amount of $117,000 for Warranty Liability.

(d) In the case of Alvarado Company, the expense warranty accrual method reflects properly the income resulting from operations in 2010 and 2011 because the warranty costs are matched with the revenues resulting from the sale, which required such costs to be incurred. Under the cash-basis method, the warranty costs appearing on the 2011 income statement are charged against unrelated revenues; 2010 net income is overstated and 2011 net income is understated.

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PROBLEM 13-8

Inventory of Premium Puppets	**60,000**	
Cash		**60,000**
(To record purchase of 40,000 puppets at €1.50 each)		
Cash	**1,800,000**	
Sales		**1,800,000**
(To record sales of 480,000 boxes at €3.75 each)		
Premium Expense	**34,500**	
Inventory of Premium Puppets		**34,500**
[To record redemption of 115,000 coupons. Computation: (115,000 ÷ 5) X €1.50 = €34,500]		
Premium Expense	**23,100**	
Premium Liability		**23,100**
[To record estimated liability for premium claims outstanding at December 31, 2011.]		

Computation: Total coupons issued in 2011	**480,000**
Total estimated redemptions (40% X 480,000)	**192,000**
Coupons redeemed in 2011	**(115,000)**
Estimated future redemptions	**77,000**

Cost of estimated claims outstanding (77,000 ÷ 5) X €1.50 = €23,100

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PROBLEM 13-9

(a) 2010

	Debit	Credit
Inventory of Premium CDs	562,500	
Cash		562,500
(To record the purchase of 250,000 CDs at $2.25 each)		
Cash	868,620	
Sales		868,620
(To record the sale of 2,895,400 candy bars at 30 cents each)		
Cash [$600,000 – (240,000 X $.50)]	480,000	
Premium Expense	60,000	
Inventory of Premium CDs		540,000
[To record the redemption of 1,200,000 wrappers, the receipt of $600,000 (1,200,000 ÷ 5) X $2.50, and the mailing of 240,000 CDs]		

Computation of premium expense:

240,000 CDs @ $2.25 each	$540,000
Postage—240,000 X $.50	120,000
	$660,000
Less: Cash received—240,000 X $2.50	600,000
Premium expense for CDs issued	$ 60,000

	Debit	Credit
Premium Expense	14,500*	
Premium Liability		14,500
(To record the estimated liability for premium claims outstanding at 12/31/10)		

*(290,000 ÷ 5) X ($2.25 + $.50 – $2.50) = $14,500

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PROBLEM 13-9 (Continued)

2011

Inventory of Premium CDs	742,500	
Cash		742,500
(To record the purchase of 330,000 CDs at $2.25 each)		
Cash	823,080	
Sales		823,080
(To record the sale of 2,743,600 candy bars at 30 cents each)		
Cash ($750,000 – $150,000)	600,000	
Premium Liability	14,500	
Premium Expense	60,500	
Inventory of Premium CDs		675,000
(To record the redemption of 1,500,000 wrappers, the receipt of $750,000 [(1,500,000 ÷ 5) X $2.50], and the mailing of 300,000 CDs.)		

Computation of premium expense:

300,000 CDs @ $2.25	$675,000
Postage—300,000 @ $.50	150,000
	825,000
Less: Cash received— (1,500,000 ÷ 5) X $2.50	750,000
Premium expense for CDs issued	75,000
Less: Outstanding claims at 12/31/10 charged to 2010 but redeemed in 2011	14,500
Premium expense chargeable to 2011	$ 60,500

Premium Expense	$ 17,500*	
Premium Liability		17,500

*(350,000 ÷ 5) X ($2.25 + $.50 – $2.50) = $17,500

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PROBLEM 13-9 (Continued)

(b)

Account	Amount 2010	Amount 2011	Classification
Inventory of Premium CDs	$22,500*	$90,000**	Current asset
Premium Liability	14,500	17,500	Current liability
Premium Expense	74,500***	78,000****	Selling expense

*$2.25 (250,000 – 240,000)
**$2.25 (10,000 + 330,000 – 300,000)
***$60,000 + $14,500
****$60,500 + $17,500

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PROBLEM 13-10

(a) Because the cause for litigation occurred before the date of the financial statements (that is, it is a present obligation as a result of past events) and because it is probable that an outflow of resources will be required to settle the obligation and a reliable estimate can be made, Windsor Airlines should report a loss and a liability in the December 31, 2010, financial statements. The loss and liability might be recorded as follows:

Loss from Uninsured Accident ($9,000,000 X 60%)	5,400,000	
Liability for Uninsured Accident		5,400,000

<u>Note to the Financial Statements</u>
Due to an accident which occurred during 2010, the Company is a defendant in personal injury suits totaling $9,000,000. The Company is charging the year of the casualty with $5,400,000 in estimated losses, which represents the amount that the company legal counsel estimates will finally be awarded.

(b) Windsor Airlines need not establish a liability for risk of loss from lack of insurance coverage itself. IFRS does not require or allow the establishment of a liability for expected future injury to others or damage to the property of others even if the amount of the losses is reasonably estimable. The cause for a loss must occur on or before the reporting date for a contingent liability to be recorded. However, the fact that Windsor is self-insured should be disclosed in a note.

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PROBLEM 13-11

(a)

	Account	Debit	Credit
1.	Loss from Uninsured Accident	250,000	
	Liability for Uninsured Accident		250,000
2.	Loss from Expropriation	1,925,000	
	Allowance for Expropriation [€5,725,000 – (40% X €9,500,000)]		1,925,000
3.	No entry required.		
4.	Loss on Lease Contract	950,000	
	Lease Contract Liability		950,000
5.	No entry required.		

(b) 1. A loss and a liability have been recorded in the first case because (i) the company has a present obligation as of the date of the financial statements as the result of a past event, (ii) it is probable that an outflow will be required to settle the obligation, and (iii) a reliable estimate can be made. That is, the occurrence of the uninsured accidents during the year plus the outstanding injury suits and the attorney's estimate of probable loss required recognition of a contingent liability.

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PROBLEM 13-11 (Continued)

2. **An entry to record a loss and establish an allowance due to threat of expropriation is necessary because the expropriation is imminent as evidenced by the foreign government's communicated intent to expropriate and the virtual certainty of a settlement from the government. That is, enough evidence exists to reasonably estimate the amount of the probable loss resulting from impairment of assets at the reporting date. The amount of the loss is measured by the amount that the carrying value (book value) of the assets exceeds the expected compensation. At the time the expropriation occurs, the related assets are written off against the allowance account. In this problem, we established a valuation account because certain specific assets were impaired. A valuation account was established rather than a liability account because the net realizability of the assets affected has decreased. A more appropriate presentation would, therefore, be provided for statement of financial position purposes on the realizability of the assets. It does not seem appropriate at this point to write off the assets involved because it may be difficult to determine all the specific assets involved, and because the assets still have not been expropriated.**

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PROBLEM 13-11 (Continued)

3. **Even though Polska's chemical product division is uninsurable due to high risk and has sustained repeated losses in the past, as of the reporting date no assets have been impaired or liabilities incurred nor is an amount reasonably estimable. Therefore, this situation does not satisfy the criteria for recognition of a contingent liability. Also, unless a casualty has occurred or there is some other evidence to indicate impairment of an asset prior to the issuance of the financial statements, there is no disclosure required relative to a contingent liability. The absence of insurance does not of itself result in the impairment of assets or the incurrence of liabilities. Expected future injuries to others or damage to the property of others, even if the amount is reasonably estimable, does not require recording a loss or a liability. The cause for loss or litigation or claim must have occurred on or prior to the reporting date and the amount of the loss must be reasonably estimable in order for a contingent liability to be recorded. Disclosure is required when one or both of the criteria for a contingent liability are not satisfied and there is a reasonable possibility that a liability may have been incurred or an asset impaired, or, it is probable that a claim will be asserted and there is a reasonable possibility of an unfavorable outcome.**

4. **By moving to another factory, Polska has a lease contract with unavoidable costs of meeting the obligations that exceed the economic benefits expected to be received. This is considered an onerous contract and the expected costs to satisfy the onerous contract should be accrued.**

5. **Possible favorable outcomes from pending court cases are considered contingent assets. Contingent assets are not recognized unless the outcome is virtually certain. The outcome in Polska's situation is not virtually certain. The evidence provided does not even support that the outcome is probable (an attorney opinion should be provided). Without evidence that the outcome is probable, the litigation should not be disclosed.**

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PROBLEM 13-12

(1)	Sales of musical instruments and sound equipment..........	$5,700,000
	Estimated warranty cost	X .02
	Warranty expense for 2010..	$ 114,000
(2)	Warranty liability—1/1/10	$ 136,000
	2010 warranty expense (Requirement 1)	114,000
	Subtotal..	250,000
	Actual warranty costs during 2010..	(164,000)
	Warranty liability—12/31/10	$ 86,000
(3)	Coupons issued (1 coupon/$1 sale)..	1,500,000
	Estimated redemption rate..	X .60
	Estimated number of coupons to be redeemed....................	900,000
	Exchange rate (200 coupons for a CD player)......................	÷ 200
	Estimated number of premium CD players to be issued.......	4,500
	Net cost of CD players ($32 – $20)..	X 12
	Premium expense for 2010..	$ 54,000
(4)	Inventory of premium CD players—1/1/10	$ 37,600
	Premium CD players purchased during 2010 (6,500 X $32).......	208,000
	Premium CD players available..	245,600
	Premium CD players exchanged for coupons during 2010 (1,200,000/200 X $32)	(192,000)
	Inventory of premium CD players—12/31/10..........................	$ 53,600
(5)	Estimated premium liability—1/1/10......................................	$ 44,800
	2010 premium expense (Requirement 3)..............................	54,000
	Subtotal..	98,800
	Actual redemptions during 2010 [1,200,000/200 X ($32 – $20)]	(72,000)
	Estimated premium liability—12/31/10	$ 26,800

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PROBLEM 13-13

1. **Memo prepared by:**
Date:

Millay Corporation
December 31, 2010

Recognition of Warranty Expense

During June of this year, the client began the manufacture and sale of a new line of dishwasher. Sales of 120,000 dishwashers during this period amounted to $60,000,000. These dishwashers were sold under a one-year warranty, and the client estimates warranty costs to be $25 per appliance (or $3,000,000).

As of the date of the statement of financial position, the client paid out $1,000,000 in warranty expenses which was also the amount expensed in its income statement. No recognition of any further liability associated with the warranty had been made.

Because Millay accounts for warranties on the accrual basis, it must recognize the entire $3,000,000 as warranty expense in the year of sale. The client should have made the following journal entries:

		Debit	Credit
(a)	**Cash/Accounts Receivable....................................**	**60,000,000**	
	Sales (120,000 X $500)...................................		**60,000,000**
	(To record sale of 120,000 dishwashers)		
(b)	**Warranty Expense ....**	**1,000,000**	
	Cash, Inventory, Accrued Payroll...............		**1,000,000**
	(To record warranty costs incurred)		
(c)	**Warranty Expense**		
	[(120,000 X $25) – $1,000,000]............................	**2,000,000**	
	Warranty Liability..		**2,000,000**
	(To accrue estimated warranty costs)		

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PROBLEM 13-13 (Continued)

2. **Memo prepared by:**
Date:

Millay Corporation
December 31, 2010

Contingent Liability from Violation Of EPA Regulations

I contacted the client's counsel via a routine attorney letter, asking for information about possible litigation in which the company might be involved. Morgan Sondgeroth, Millay's attorney, informed me about court action taken against Millay for dumping toxic waste in the Kishwaukee River.

Although the litigation is pending, Sondgeroth believes that the suit will probably be lost. A reliable estimate of clean up costs and fines is $2,750,000. The client neither disclosed nor accrued this loss in the financial statements.

Because this obligation existed as of the date of the statement of financial position, it is probable that resources will be used to settle the obligation, and an amount can be reliably estimated, it must be accrued as a provision. I advised the client to record the following entry to accrue this liability.

Loss from Environmental Cleanup	2,750,000	
Environmental Cleanup Liability		2,750,000

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PROBLEM 13-13 (Continued)

3. **Memo prepared by:**
Date:

Millay Corporation
December 31, 2010

Contingent Liability on
Patent Infringement Litigation

In answer to my attorney letter requesting information about any possible litigation associated with the client, Morgan Sondgeroth informed me that the client is in the middle of a patent infringement suit with Megan Drabek over a hydraulic compressor used in several of Millay's appliances. The loss of this suit is possible. Millay did not in any way disclose this information.

Because the loss is possible, but not probable, and can be estimated at $5,000,000, it should be disclosed in the notes to the financial statements. I advised the client to include as a footnote to the financial statements a discussion of this pending litigation along with the attorney's assessment that the loss is possible. In addition, I advised the client to disclose the estimated amount of this contingent liability.

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PROBLEM 13-14

1. **Estimated warranty costs:**

On 2009 sales $ 800,000 X .10	$ 80,000
On 2010 sales $1,100,000 X .10	110,000
On 2011 sales $1,200,000 X .10	120,000
Total estimated costs	310,000
Total warranty expenditures	(85,700*)
Balance of liability, 12/31/11	$224,300

*2009—$6,500; 2010—$17,200, and 2011—$62,000.

The liability account has a balance of $224,300 at 12/31/11 based on the difference between the estimated warranty costs (totaling $310,000) for the three years' sales and the actual warranty expenditures (totaling $85,700) during that same period.

2. **Computation of liability for premium claims outstanding:**

Unredeemed coupons for 2011 ($9,000 – $8,000)	$ 1,000
2011 coupons estimated to be redeemed ($30,000 X .40)	12,000
Total	$13,000

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TIME AND PURPOSE OF CONCEPTS FOR ANALYSIS

CA 13-1 (Time 20–25 minutes)
Purpose—to provide the student with the opportunity to define a liability, to distinguish between current and non-current liabilities, and to explain accrued liabilities. The student must also describe how liabilities are valued, explain why notes payable are usually reported first in the current liabilities section, and to indicate the items that may comprise "compensation to employees."

CA 13-2 (Time 15–20 minutes)
Purpose—to provide the student with three situations that require the application of judgment about the current or non-current nature of the items. The student must think about when typical short-term items might not be classified as current.

CA 13-3 (Time 30–40 minutes)
Purpose—to provide the student with a comprehensive case covering refinancing of short-term debt. Four situations are presented in which the student must determine the proper classification and disclosure of the debt in the financial statements. In order to thoroughly resolve the issues presented, the student is expected to research the IFRS.

CA 13-4 (Time 15–20 minutes)
Purpose—to provide the student with an opportunity to comment on the proper treatment in the financial statements of a contingent liability incurred after the reporting date but before issuance of the financial statements. In order to thoroughly answer the case the student will need to understand IAS 1.

CA 13-5 (Time 15–20 minutes)
Purpose—to provide the student with an opportunity to specify the conditions by which a contingent liability can be recorded in the accounts. The student is also required to indicate the proper disclosure in the financial statements of the situations where the amount of loss cannot be reliabily estimated.

CA 13-6 (Time 15–20 minutes)
Purpose—to provide the student with an opportunity to discuss how product warranty costs and the fact that a company is being sued should be reported.

CA 13-7 (Time 20–25 minutes)
Purpose—to provide the student with an opportunity to examine the ethical issues related to estimates for bad debts and warranty obligations.

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SOLUTIONS TO CONCEPTS FOR ANALYSIS

CA 13-1

(a) A liability is defined as a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits. In other words, it is an obligation to transfer some type of resource in the future as a result of a past transaction.

(b) Current liabilities are obligations that are (1) expected to be settled within its normal operating cycle; or (2) expected to be settled within twelve months after the reporting date.

(c) Accrued liabilities (sometimes called accrued expenses) arise through accounting recognition of unpaid expenses that come into existence as a result of past contractual commitments or past services received. Examples are wages payable, salaries payable, interest payable, property taxes payable, income tax payable, payroll taxes payable, bonus payable, postretirement benefits payable, and so on.

(d) Theoretically, liabilities should be measured by the present value of the future outlay of cash required to liquidate them. But in practice, current liabilities are usually recorded in accounting records and reported in financial statements at their maturity value. Because of the short time periods involved—frequently less than one year—the difference between the present value of a current liability and the maturity value is not large. The slight overstatement of liabilities that results from carrying current liabilities at maturity value is accepted on the grounds it is immaterial.

(e) Notes payable are listed first in the statement of financial position because in liquidation they would probably be paid first.

(f) The item compensation to employees might include:

1. Wages, salaries, or bonuses payable.
2. Compensated absences payable.
3. Postretirement benefits payable.

CA 13-2

1. Since the notes payable are due in less than one year from the reporting date, they would generally be reported as a current liability. The only situation in which this short-term obligation could possibly be excluded from current liabilities is if Rodriguez Corp. intends to refinance it. For those notes to qualify for exclusion from current liabilities, the company must meet the following criteria:

   (1) It must intend to refinance the obligation on a long-term basis, and
   (2) It must have an unconditional right to defer settlement of the liability for at least 12 months after the reporting date.

   Entering into a financing arrangement that clearly permits the company to refinance the debt on a long-term basis on terms that are readily determinable before the next reporting date is one way to satisfy the second condition.

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CA 13-2 (Continued)

2. Generally, deposits from customers would be classified as a current liability. However, the classification of deposits as current or non-current depends on the time involved between the date of deposit and the termination of the relationship that required the deposit. In this case, the $6,250,000 would be excluded from current liabilities only if the equipment would not be delivered for more than one year (or one operating cycle).

3. Salaries payable is an accrued liability which in almost all circumstances would be reported as a current liability (could not be excluded).

CA 13-3

(a) No. IFRS indicate that refinancing a short-term obligation on a long-term basis also requires that a company have an unconditional right to defer settlement of the liability for at least 12 months after the reporting date.

(b) No. The events described will not have an impact on the financial statements. Since Kobayashi Corporation's refinancing of the long-term debt maturing in March 2011 does not meet the conditions set forth in **IFRS** that obligation should be included in current liabilities. The ¥10,000,000 should continue to be classified as current at December 31, 2010.

A short-term obligation, other than one classified as a current liability, shall be excluded from current liabilities if the entity's intent to refinance the short-term obligation on a long-term basis is supported by an unconditional right to defer the settlement of the liability for at least 12 months after the reporting date.

(c) Yes. The debt should be included in current liabilities. The issuance of ordinary shares in January does not meet the criteria to have an unconditional right to defer the settlement of the liability for at least 12 months after the reporting date.

(d) Yes. The ¥10,000,000 should be shown as a current liability on the December 31, 2010 statement of financial position. While the terms of the agreement permit management to refinance on a long-term basis, the agreement was not in force at December 31, 2010.

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CA 13-4

Because the casualty occurred subsequent to the reporting date, it meets the criteria of a contingent liability; that is, an asset had not been impaired or a liability incurred at the reporting date. Contingent liabilities are not be accrued by a charge to expense due to the explosion. However, because it had become known before the financial statements were issued that assets were impaired and liabilities were incurred after the reporting date, disclosure is necessary to keep the financial statements from being misleading. The financial statements should indicate the nature of and an estimate of the loss to the company's assets as a result of the explosion and the nature of and an estimate of the contingent liability anticipated from suits that will be filed and claims asserted for injuries and damages.

If the loss to assets or the liability incurrence can be reasonably estimated, disclosure may best be made by supplementing the historical financial statements with pro forma financial data giving effect to the loss as if it had occurred at the date of the financial statements.

CA 13-5

(a) Three conditions must exist before a provision is recorded:

1. A company has present obligation (legal or constructive) as a result of a past event.
2. It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation;
3. A reliable estimate can be made of the amount of the obligation.

(b) When some amount within the range appears at the time to be a better estimate than any other amount within the range, that amount is accrued. When no amount within the range is a better estimate than any other amount, the expected dollar amount (the midpoint) of the range is accrued.

(c) The following disclosure in the notes is required:

1. The nature of the contingent liability.
2. An estimate of the possible loss or range of loss or a statement that an estimate cannot be made.
3. An estimate of its financial effect.
4. An indication of uncertainties related to the amount or timing of payment; and
5. The possibility of any reimbursement.

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CA 13-6

Part 1. For Product Grey, the estimated product warranty costs should be accrued by a charge to expense and a credit to a liability because the following conditions were met:

1. A company has a present obligation (legal or constructive) as a result of a past event;
2. It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation;
3. A reliable estimate can be made of the amount of the obligation (1% of sales).

For Product Yellow, the estimated product warranty costs should not be accrued by a charge to income because the amount of loss cannot be reliably estimated. Since only two of the conditions are satisfied, a disclosure by means of a note should be made.

Part 2. The probable judgment (£1,000,000) should be accrued by a charge to expense and a credit to a liability because the following conditions were met.

1. A company has a present obligation (legal or constructive) as a result of a past event.
2. It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation because Constantine's lawyer states that it is probable that Constantine will lose the suit.
3. A reliable estimate can be made of the amount of the obligation because Constantine's lawyer states that the most probable judgment is £1,000,000.

Constantine should disclose in its financial statements or notes the following:

The amount of the suit (£4,000,000).
The nature of the accrual.
The nature of the provision.
The range of possible loss (£400,000 to £2,000,000).

CA 13-7

(a) No, Hamilton should not follow his owner's directive if his (Hamilton's) original estimates are reasonable.

(b) Rich Clothing Store benefits in lower rental expense. The Dotson Company is harmed because the misleading financial statement deprives it of its rightful rental fees. In addition, the current shareholders of Rich Clothing Store are harmed because the lower net income reduces the current value of their holdings.

(c) Rich is acting unethically to avoid the terms of his rental agreement at the expense of his landlord and his own shareholders.

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FINANCIAL REPORTING PROBLEM

(a) M&S's short-term borrowings were £928.6 million at March 29, 2008.

SHORT-TERM DEBT

(In millions)	2008
Bank loans	£257.4
Syndicated bank facility	615.0
Finance lease liabilities	6.2
Total	878.6
Partnership liability to M&S	
UK pension scheme	50.0
Total short-term debt	£928.6

The weighted-average interest rate is only provided for the Partnership liability to M&S UK pension scheme (5.7%) and the finance lease liabilities (5.0%).

(b) 1. Working capital = Current assets less current liabilities.

(£807,200,000) = (£1,181,700,000 – £1,988,900,000)

2. $$\text{Acid-test ratio} = \frac{\text{Cash + short-term investments + net receivables}}{\text{Current liabilities}}$$

$$0.35 \text{ times} = \frac{£318{,}000{,}000 + £18{,}400{,}000 + £307{,}600{,}000 + £48{,}800{,}000}{£1{,}988{,}900{,}000}$$

3. $$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

$$0.59 \text{ times} = \frac{£1{,}181{,}700{,}000}{£1{,}988{,}900{,}000}$$

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While M&S's current and acid-test ratios are below one, this may not indicate a weak liquidity position. Many large companies carry relatively high levels of accounts payable, which charge no interest. For example, M&S has almost £1 billion of these short-term obligations, which can be viewed as very cheap forms of financing. Nonetheless, its short-term debt (see part (a)) has increased significantly (from £461 million to £879 million) in 2008, which raises some liquidity/working capital concerns. Combine this with the negative working capital and liquidity appears to be a problem. Comparisons to industry are required to fully assess liquidity.

(c) M&S provided the following discussion related to commitments and contingencies:

28 Contingencies and commitments

A Capital commitments

	2008 £m	2007 £m
Commitments in respect of properties in the course of construction	182.8	265.8

B Other material contracts

In the event of a material change in the trading arrangements with certain warehouse operators, the Group has a commitment to purchase property, plant and equipment, at values ranging from historical net book value to market value, which are currently owned and operated by them on the Group's behalf.

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C Commitments under operating leases

The Group leases various stores, offices, warehouses and equipment under non-cancellable operating lease agreements. The leases have varying terms, escalation clauses and renewal rights.

	2008 £m	2007 £m
Total future minimum rentals under non-cancellable operating leases expiring:		
Not later than one year	**17.9**	**10.6**
Later than one year and not later than five years	**90.4**	**57.4**
Later than five years and not later than 25 years	**2,223.6**	**1,778.3**
Later than 25 years	**1,492.4**	**1,527.6**
Total	**3,824.3**	**3,373.9**

The total future sublease payments to be received are £70.5m (last year £68.8m).

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COMPARATIVE ANALYSIS CASE

(a) The working capital position of the two companies is as follows:

Cadbury

Current assets	**£ 2,635,000,000**
Current liabilities	**(3,388,000,000)**
Working capital	**£ (753,000,000)**

Nestle

Current assets	**CHF33,048,000,000**
Current liabilities	**(33,223,000,000)**
Working capital	**CHF (175,000,000)**

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COMPARATIVE ANALYSIS CASE (Continued)

(b) The overall liquidity of both companies is good as indicated from the ratio analysis provided below (all computations in millions):

	Cadbury	Nestle
Current cash debt coverage ratio	$\frac{£469}{\frac{£3,388 + £4,614}{2}} = .12$	$\frac{CHF10,763}{\frac{CHF33,223 + CHF43,326}{2}} = .28$
Cash debt coverage ratio	$\frac{£469}{\frac{£5,361 + £7,165}{2}} = .07$	$\frac{CHF10,763}{\frac{CHF51,299 + CHF60,585}{2}} = .19$
Current ratio	$\frac{£2,635}{£3,388} = 0.78$	$\frac{CHF33,048}{CHF33,223} = .99$
Acid-test ratio	$\frac{£251 + £247 + £1,067 + £268}{£3,388} = .54$	$\frac{CHF5,835 + CHF1,296 + CHF13,442 + CHF1,609}{CHF33,223} = .67$

<u>Note to Instructor:</u> For purposes of calculating the acid-test ratio, financial derivative assets are included in the numerator because these are similar to short-term investments.

	Cadbury	Nestle
Receivables turnover	$\frac{£5,384}{\frac{£1,067 + £1,197}{2}} = 4.76$	$\frac{CHF109,908}{\frac{CHF13,442 + CHF14,890}{2}} = 7.76$
Inventory turnover	$\frac{£2,870}{\frac{£767 + £821}{2}} = 3.61$	$\frac{CHF47,339}{\frac{CHF9,342 + CHF9,272}{2}} = 5.09$

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(c) Nestle discusses its contingencies in the following two notes:

18. Provisions and contingencies

18.2 Contingencies

The Group is exposed to contingent liabilities amounting to a maximum potential payment of CHF 644 million (2007: CHF 1016 million) representing potential litigations of CHF 590 million (2007: CHF 956 million) and other items of CHF 54 million (2007: CHF 60 million). Contingent assets for litigation claims in favour of the Group amount to a maximum potential recoverable of CHF 296 million (2007: CHF 395 million).

25. Lease commitments

25.1 Operating leases

Lease commitments refer mainly to buildings, industrial equipment, vehicles and IT equipment.

	2008	2007
	Minimum lease payments	
In millions of CHF	Future value	
Within one year	609	559
In the second year	487	425
In the third to the fifth year inclusive	918	859
After the fifth year	524	571
	2,538	2,414

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25.2 Finance leases

	2008		2007	
	Minimum lease payments			
In millions of CHF	Present value	Future value	Present value	Future value
Within one year	65	67	78	88
In the second year	54	64	100	120
In the third to the fifth year inclusive	101	139	146	208
After the fifth year	74	181	122	264
	294	451	446	680

The difference between the future value of the minimum lease payments and their present value represents the discount on the lease obligations.

Cadbury discusses its contingencies in the following two notes:

32. Leasing commitments

(i) Group
(a) Finance leases

	Minimum lease payments		Present value of minimum lease payments	
	2008 £m	2007 £m	2008 £m	2007 £m
On leases expiring:				
Within one year	1	22	1	21
Between one and five years	1	10	1	7
After five years	–	4	–	4
	2	36	2	32
Less future finance charges	–	(4)		
Present value of lease obligations	2	32		
Amount due for settlement within 12 months	1	21		
Amount due for settlement after 12 months	1	11		

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It is the Group's policy to lease certain of its plant and equipment under finance leases. Interest rates are fixed at the contract date. All leases are on a fixed repayment basis and no arrangements are entered into for contingent rental payments. The carrying value of the Group's lease obligations approximates their fair value.

(b) Operating leases

At the balance sheet date, the Group had outstanding commitments for future minimum lease payments under non-cancellable operating leases, which fall due as follows:

	2008 £m	Re-presented 2007 £m
Within one year	44	35
Between one and five years	140	104
After five years	94	98
	278	237

	2008 £m	Re-presented 2007 £m
Operating lease expenses charged in the income statement	45	53

(ii) Company

The Company has no lease commitments or operating leases.

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33. Contingent liabilities and financial commitments.

(a) Cadbury Holdings Limited, a subsidiary of the Company, has guaranteed borrowings and other liabilities of certain subsidiary undertakings, the amounts outstanding and recognised on the Group balance sheet at 31 December 2008 being £2,185 million (2007: £3,470 million). In addition, certain of the Company's subsidiaries have guaranteed borrowings of certain other subsidiaries. The amount covered by such arrangements at 31 December 2008 was £1,693 million (2007: £2,017 million). Payment under these guarantees would be required in the event that the relevant subsidiary was unable to pay the guaranteed borrowings when due. These guarantees cover the Group's borrowings of £2,385 million (2007: £3,714 million) and have the same maturity.

(b) Subsidiary undertakings have guarantees and indemnities outstanding amounting to £18 million (2007: £7 million).

(c) The Group has given a number of indemnities on certain disposals including the demerger of the Americas Beverages business as to the ownership of assets and intellectual property, all outstanding tax liabilities, environmental liabilities and product liability claims. These may expire over a period of time up to the local statute of limitations although for ownership of assets and intellectual property these may be indefinite. Where appropriate the Group has made provisions for any liabilities which may crystallise.

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COMPARATIVE ANALYSIS CASE (Continued)

(d) Credit risk represents the accounting loss that would be recognised at the reporting date if counterparties failed completely to perform as contracted. Concentrations of credit risk (whether on or off balance sheet) that arise from financial instruments exist for groups of customers or counterparties when they have similar economic characteristics that would cause their ability to meet contractual obligations to be similarly affected by changes in economic or other conditions. The Group does not have a significant exposure to any individual customer, counterparty, or to any geographical region. The Group conducts business with banks representing many nationalities, in most cases through offices and branches located in London and maintains strict limits over its exposure to any individual counterparty.

(e) Group companies are defendants in a number of legal proceedings incidental to their operations. The Group does not expect that the outcome of such proceedings either individually or in the aggregate will have a material effect on the Group's operations, cash flows or financial position.

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FINANCIAL STATEMENT ANALYSIS CASE 1

NORTHLAND CRANBERRIES

(a) **Working capital is calculated as current assets—current liabilities, while the current ratio is calculated as current assets/current liabilities. For Northland Cranberries these ratios are calculated as follows:**

	Current year	Prior year
Working capital	$6,745,759 – $10,168,685 = $–3,422,926	$5,598,054 – $4,484,687 = $1,113,367
Current ratio	($6,745,759/$10,168,685) = .66	($5,598,054/$4,484,687) = 1.25

Historically, it was generally believed that a company should maintain a current ratio of at least 2.0. In recent years, because companies have been able to better maintain their inventory, receivables and cash, many healthy companies have ratios well below 2.0. However, Northland Cranberries has negative working capital in the current year, and current ratios in both years are extremely low. This would be cause for concern and additional investigation. As you will see in the next discussion point, there may well be a reasonable explanation.

(b) **This illustrates a potential problem with ratios like the current ratio, that rely on statement of financial condition numbers that present a company's financial position at a particular point in time. That point in time may not be representative of the average position of the company during the course of the year, and also, that point in time may not be the most relevant point for evaluating the financial position of the company. If the company does not like the representation that these commonly used measures give of the company's position, it could change its year-end or suggest other measures that it considers to be more relevant for a company in this business. Also, it is possible that by using averages calculated across quarterly data some of this problem might be alleviated. As discussed in Chapter 5, there are measures that employ cash flows, which addresses at least part of the point-in-time problem of statement of financial position ratios.**

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FINANCIAL STATEMENT ANALYSIS CASE 2

SUZUKI COMPANY

(a) **Under the cash basis, warranty costs are charged to expense as they are incurred; in other words, warranty costs are charged in the period in which the seller or manufacturer performs in compliance with the warranty. No liability is recorded for future costs arising from warranties, nor is the period in which the sale is recorded necessarily charged with the costs of making good on outstanding warranties.**

If it is probable that customers will make claims under warranties relating to goods or services that have been sold, and a reasonable estimate of the costs involved can be made, the accrual method must be used. Under the accrual method, a provision for warranty costs is made in the year of sale or in the year that the productive activity takes place.

(b) **When the warranty is sold separately from the product, the sales warranty approach is employed. Revenue on the sale of the extended warranty is deferred and is generally recognized on a straight-line basis over the life of the contract. Revenue is deferred because the seller of the warranty has an obligation to perform services over the life of the contract.**

(c) **The general approach is to use the straight-line method to recognize deferred revenue on warranty contracts. If historical evidence indicates that costs incurred do not follow a straight-line approach, then revenue should be recognized over the contract period in proportion to the costs expected to be incurred in performing services under the contract. Only costs that vary with and are directly related to the acquisition of the contracts (mainly commissions) should be deferred and amortized. Costs such as employee's salaries, advertising, and general and administrative expenses that would have been incurred even if no contract were acquired should be expensed as incurred.**

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FINANCIAL STATEMENT ANALYSIS CASE 3

(a) **BOP's working capital and current ratio have declined in 2010 compared to 2009. While this would appear to be bad news, the acid test ratio has improved. This is due to BOP carrying relatively more liquid receivables in 2010 (receivable days has increased.) And while working capital has declined, the amount of the operating cycle that must be financed with more costly borrowing has declined. That is, BOP is using relatively inexpensive accounts payable to finance its operating cycle. Note that the overall operating cycle has declined because inventory is being managed at a lower level (inventory days has declined by more than 60 days.)**

(b) **Answers will vary depending on the companies selected. This activity is a great spreadsheet exercise. The analysis for U.S. retailers Best Buy and Circuit City is presented below.**

	Best Buy (in 000,000)			Circuit City (in 000)		
	2005	2006	2007	2005	2006	2007
Cash	$ 470	$748	1,205	879,660	315,970	141,141
Accounts Receivable	375	449	548	230,605	222,869	382,555
Inventory	2,851	3,338	4,028	1,455,170	1,698,026	1,636,507
Accounts Payable	2,824	3,234	3,934	635,674	850,359	922,205
Purchases	20,496	22,432	31,193	7,618,508	8,765,202	11,137,945
Cost of Goods Sold	20,983	23,122	27,165	7,861,364	8,703,683	9,501,438
Sales		30,848	35,934	10,413,524	11,514,151	12,429,754
Operating Cycle						
Receivable Days		5.3	5.6		7.1	11.2
Inventory Days		52.7	54.1		71.2	62.9
Operating Cycle		58.0	59.7		78.3	74.1
Less: Accounts Payable Days		52.62	46.03		35.41	30.22
Days to be Financed		5.38	13.67		42.89	43.88
Working Capital		$1,301	$1,847		$1,386,506	$1,237,998
Current Ratio		1.40	1.47		2.63	2.34
Acid Test Ratio		0.37	0.45		0.63	0.57

Best Buy reports both a lower current ratio and acid-test ratio. However, much more of Best Buy's operating cycle in financed with relatively inexpensive accounts payable as indicated by Best Buy's longer payable days. Note that circuit city declared bankruptcy in 2009.

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ACCOUNTING, ANALYSIS, AND PRINCIPLES

ACCOUNTING

During 2010		
Warranty Expense	6,000	
Cash		6,000
12/31/10		
Warranty Expense	45,000	
Warranty Liability		45,000
02/28/10		
Interest Expense	3,333	
Interest Payable	1,667	
Cash		5,000

€1,667 = (€200,000 X.10) X 1/12
€3,333 = (€200,000 X .10) X 2/12

05/31/10		
Interest Expense	5,000	
Cash		5,000
08/31/10		
Interest Expense	5,000	
Cash		5,000
11/30/10		
Interest Expense	5,000	
Cash		5,000
12/31/10		
Interest Expense	1,667	
Interest Payable		1,667

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01/01/10		
Manufacturing Facility (PPE)	**5,192,770**	
Cash		**5,000,000**
Environmental Liability (€500,000 X 0.38554)		**192,770**
12/31/10		
Depreciation Expense	**51,928**	
Accumulated Depreciation		**51,928**
Interest Expense	**19,277**	
Environmental Liability		**19,277**

ANALYSIS

The warranty liability and the interest payable are current liabilities, so all else being equal, these will decrease both the current and acid-test ratios. Because of the commitment letter from UBS, the €200,000 loan can be classified as a non-current liability. Without this letter, YellowCard would likely not be able to demonstrate the ability to defer settlement of the liability for at least 12 months. This would mean the €200,000 loan would have to be classified as a current liability, further depressing YellowCard's current and acid-test ratios. The environmental liability can be classified as a non-current liability, so it will not affect the current and acid-test ratios.

PRINCIPLES

According to the IASB Framework, liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events. With respect to the new warranty plan, YellowCard would be currently obligated to provide repair service to its customers, arising from the prior sales of its products. So even though customers are making an upfront payment, YellowCard still has an obligation to provide services in the future. Thus the company should record the payments as unearned revenue until it is no longer obligated to make repairs. That is, the current accounting reflects application of the expense warranty approach. The new plan would be accounted for under the sales warranty approach, which defers a certain percentage of the original sales price until some future time when the company incurs actual costs or the warranty expires.

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PROFESSIONAL RESEARCH

(a) IAS 37, Provisions, Contingent Liabilities and Contingent Assets.

(b) Recognizing a liability from restructuring (IAS 37, 72 – 79)

A constructive obligation to restructure arises only when an entity:

(a) has a detailed formal plan for the restructuring identifying at least: (i) the business or part of a business concerned; (ii) the principal locations affected; (iii) the location, function, and approximate number of employees who will be compensated for terminating their services; (iv) the expenditures that will be undertaken; and (v) when the plan will be implemented; and

(b) has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.

Evidence that an entity has started to implement a restructuring plan would be provided, for example, by dismantling plant or selling assets or by the public announcement of the main features of the plan. A public announcement of a detailed plan to restructure constitutes a constructive obligation to restructure only if it is made in such a way and in sufficient detail (ie setting out the main features of the plan) that it gives rise to valid expectations in other parties such as customers, suppliers and employees (or their representatives) that the entity will carry out the restructuring.

For a plan to be sufficient to give rise to a constructive obligation when communicated to those affected by it, its implementation needs to be planned to begin as soon as possible and to be completed in a timeframe that makes significant changes to the plan unlikely. If it is expected that there will be a long delay before the restructuring begins or that the restructuring will take an unreasonably long time, it is unlikely that the plan will raise a valid expectation on the part of others that the entity is at present committed to restructuring, because the timeframe allows opportunities for the entity to change its plans.

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A management or board decision to restructure taken before the end of the reporting period does not give rise to a constructive obligation at the end of the reporting period unless the entity has, before the end of the reporting period: (a) started to implement the restructuring plan; or (b) announced the main features of the restructuring plan to those affected by it in a sufficiently specific manner to raise a valid expectation in them that the entity will carry out the restructuring. If an entity starts to implement a restructuring plan, or announces its main features to those affected, only after the reporting period, disclosure is required under IAS 10 *Events after the Reporting Period*, if the restructuring is material and non-disclosure could influence the economic decisions that users make on the basis of the financial statements.

Although a constructive obligation is not created solely by a management decision, an obligation may result from other earlier events together with such a decision. For example, negotiations with employee representatives for termination payments, or with purchasers for the sale of an operation, may have been concluded subject only to board approval. Once that approval has been obtained and communicated to the other parties, the entity has a constructive obligation to restructure, if the conditions of paragraph 72 are met.

In some countries, the ultimate authority is vested in a board whose membership includes representatives of interests other than those of management (eg employees) or notification to such representatives may be necessary before the board decision is taken. Because a decision by such a board involves communication to these representatives, it may result in a constructive obligation to restructure.

No obligation arises for the sale of an operation until the entity is committed to the sale, ie there is a binding sale agreement.

Even when an entity has taken a decision to sell an operation and announced that decision publicly, it cannot be committed to the sale until a purchaser has been identified and there is a binding sale agreement. Until there is a binding sale agreement, the entity will be able to change its mind and indeed will have to take another course of action if a purchaser cannot be found on acceptable terms. When the sale of an operation is envisaged as part of a restructuring, the assets of the operation are reviewed for impairment, under IAS 36. When a sale is only part of a restructuring, a constructive obligation can arise for the other parts of the restructuring before a binding sale agreement exists.

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PROFESSIONAL RESEARCH (Continued)

Costs to include (IAS 37, 80)

A restructuring provision shall include only the direct expenditures arising from the restructuring, which are those that are both: (a) necessarily entailed by the restructuring; and (b) not associated with the ongoing activities of the entity.

Costs to exclude (IAS 37, 81 – 82)

A restructuring provision does not include such costs as: (a) retraining or relocating continuing staff; (b) marketing; or (c) investment in new systems and distribution networks. These expenditures relate to the future conduct of the business and are not liabilities for restructuring at the end of the reporting period. Such expenditures are recognised on the same basis as if they arose independently of a restructuring.

Identifiable future operating losses up to the date of a restructuring are not included in a provision, unless they relate to an onerous contract as defined in paragraph 10.

As required by paragraph 51, gains on the expected disposal of assets are not taken into account in measuring a restructuring provision, even if the sale of assets is envisaged as part of the restructuring.

(c) The current warranty contract is considered an onerous contract. The required accounting related to an onerous contract is in IAS 37, 81 – 82.

If an entity has a contract that is onerous, the present obligation under the contract shall be recognised and measured as a provision.

Many contracts (for example, some routine purchase orders) can be cancelled without paying compensation to the other party, and therefore there is no obligation. Other contracts establish both rights and obligations for each of the contracting parties. Where events make such a contract onerous, the contract falls within the scope of this Standard and a liability exists which is recognised. Executory contracts that are not onerous fall outside the scope of this Standard.

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PROFESSIONAL RESEARCH (Continued)

This Standard defines an onerous contract as a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. The unavoidable costs under a contract reflect the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfil it.

Before a separate provision for an onerous contract is established, an entity recognises any impairment loss that has occurred on assets dedicated to that contract (see IAS 36).

Hincapie shoud therefore record a liability for the service contract at €75,000, the amount of the termination fee.

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PROFESSIONAL SIMULATION

Journal Entries

(a)

Unearned Subscriptions Revenue	400,000	
Subscriptions Revenue		400,000
(To record subscriptions earned during 2010)		

Book balance of liability account at December 31, 2010	$2,300,000
Adjusted balance ($600,000 + $500,000 + $800,000)	(1,900,000)
Credit to revenue account	$ 400,000

(b) No entry should be made to accrue for an expense, because the absence of insurance coverage does not mean that an asset has been impaired or a liability has been incurred as of the reporting date. Appropriation of retained earnings is discussed in more detail in Chapter 15.

Note to instructor: The company may, however, appropriate retained earnings for self-insurance as long as actual costs or losses are not charged to the appropriation of retained earnings and no part of the appropriation is transferred to income. Appropriation of retained earnings and/or disclosure in the notes to the financial statements are not required, but are recommended.

(c)

Loss from Pending Lawsuit	540,000*	
Liability from Pending Lawsuit		540,000
(To record expected value of the probable loss on breach-of-contract litigation)		

*$300,000 X 40% + $700,000 X 60% = $540,000.

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Explanation

If a liability is expected to be settled within its normal operating cycle; or within twelve months after the reporting date, then the liability is classified as current. Current liabilities will be settled (retired, discharged, paid) by the use of a resource properly classified as a current asset or by the creation of another current liability. All other obligations are classified as noncurrent liabilities.

A company can exclude a short-term obligation from current liabilities only if the following conditions are met:

(1) It must intend to refinance the obligation on a long-term basis, and
(2) It must have an unconditional right to defer settlement of the liability for at least 12 months after the reporting date.

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