

CHAPTER 13

NON-FINANCIAL AND CURRENT LIABILITIES

ASSIGNMENT CLASSIFICATION TABLE

Topics	Brief Exercises	Exercises	Problems	Writing Assignments
1. Concept of liabilities; definition and classification.	1	1	1	2, 5
2. Current liabilities including accounts and notes payable, dividends payable, sales and income tax payable and short-term obligations expected to be refinanced.	2, 3, 4, 5, 6, 7, 8, 9, 10, 11, 12	2, 3, 4, 5, 6, 7, 8	1, 2, 3, 4	
3. Employee-related liabilities.	13, 14, 15, 16, 17	6, 9, 10, 11, 12, 13	3, 5, 6, 7	4
4. Asset retirement obligations.	18, 19, 20	14, 15	1, 4, 8	1
5. Unearned revenues, product guarantees, warranties and other customer programs.	21, 22, 23, 24	6, 16, 17, 18, 19, 20, 21, 22, 23	1, 3, 4, 9, 10, 11, 12, 13, 14, 15	1, 3
6. Contingencies, guarantees and uncertain commitments.	25, 26	6, 24	8, 9, 16, 17	1, 3, 4
7. Presentation and analysis.	27	25, 26, 27	3, 8, 9, 17	5

ASSIGNMENT CHARACTERISTICS TABLE

Item	Description	Level of Difficulty	Time (minutes)
E13-1	Balance sheet classification of various liabilities.	Simple	10-15
E13-2	Accounts and notes payable.	Moderate	20-25
E13-3	Liability for returnable containers.	Moderate	15-20
E13-4	Entries for sales tax.	Simple	20-30
E13-5	Income Tax.	Moderate	15-20
E13-6	Financial statement impact of liability transactions.	Moderate	30-35
E13-7	Refinancing of short-term debt.	Simple	10-12
E13-8	Refinancing of short-term debt.	Simple	10-15
E13-9	Payroll tax entries.	Simple	15-20
E13-10	Compensated absences – vacation and sick pay.	Moderate	25-30
E13-11	Compensated absences – vacation and sick pay.	Moderate	25-30
E13-12	Compensated absences – parental benefits.	Moderate	25-30
E13-13	Bonus calculation and income statement preparation.	Complex	15-20
E13-14	Asset retirement obligation.	Moderate	20-25
E13-15	Asset retirement obligation.	Moderate	25-35
E13-16	Warranties – expense approach and cash basis.	Simple	10-15
E13-17	Warranties – expense approach.	Moderate	15-20
E13-18	Warranties – expense approach and revenue approach.	Moderate	20-25
E13-19	Warranties – expense approach and revenue approach.	Moderate	15-20
E13-20	Premiums.	Moderate	15-20
E13-21	Premiums.	Moderate	20-30
E13-22	Premiums.	Simple	10-15
E13-23	Coupons and rebates.	Moderate	15-20
E13-24	Contingencies and commitments.	Moderate	20-30
E13-25	Ratio calculations and discussion.	Simple	15-20
E13-26	Ratio calculations and analysis.	Simple	20-25
E13-27	Ratio calculations and effect of transactions.	Moderate	15-25

ASSIGNMENT CHARACTERISTICS TABLE (Continued)

Item	Description	Level of Difficulty	Time (minutes)
P13-1	Current liability entries and adjustments.	Simple	40-50
P13-2	Instalment note.	Moderate	30-35
P13-3	Current liabilities: various.	Complex	45-55
P13-4	Asset retirement obligation and warranties.	Moderate	25-35
P13-5	Payroll tax entries.	Moderate	20-30
P13-6	Payroll tax entries.	Moderate	20-25
P13-7	Bonus calculation.	Moderate	25-30
P13-8	Loss contingencies: entries and essay.	Moderate	45-50
P13-9	Advances, self-insurance, loss contingencies, guarantees and commitments.	Moderate	25-30
P13-10	Warranties, accrual and cash basis.	Simple	20-25
P13-11	Extended sales warranties.	Moderate	20-30
P13-12	Warranty calculations.	Moderate	20-25
P13-13	Premium entries.	Moderate	30-45
P13-14	Premium entries and financial statement presentation.	Moderate	30-45
P13-15	Warranties and premiums.	Simple	25-30
P13-16	Guarantees and contingencies.	Complex	35-45
P13-17	Loss contingencies: entries and essays.	Moderate	45-50

SOLUTIONS TO BRIEF EXERCISES

BRIEF EXERCISE 13-1

- (a) Working capital is the excess of total current assets over total current liabilities. It represents the liquid buffer that is available to meet the financial demands of the company's operating cycle. Current liabilities place a demand on the company's current assets. Management of the due dates of current liabilities and management of current assets to generate cash on a timely basis are important for effective management of business operations. Effective management of working capital to achieve high liquidity may also contribute to positive cash from operating activities as seen on the statement of cash flows.
- (b) Wellson can improve its management of working capital by focusing on management of current liabilities as well as current assets. For example, if Wellson has a cash flow shortage, it can take advantage of the full credit period extended by its suppliers. As another example, Wellson may also time the due dates of short-term notes payable to coincide with expected periods of positive cash flow.

BRIEF EXERCISE 13-2

07/01	Purchases	60,000	
	Accounts Payable		60,000
	Freight-in	1,200	
	Cash		1,200
07/03	Accounts Payable	6,000	
	Purchase Returns and Allowances ..		6,000
07/10	Accounts Payable	54,000	
	Cash		52,920
	Purchase Discounts		1,080

BRIEF EXERCISE 13-3

07/01	Purchases (\$60,000 X 98%)	58,800	
	 Accounts Payable		58,800
	Freight-in	1,200	
	 Cash		1,200
07/03	Accounts Payable (\$6,000 X 98%)	5,880	
	 Purchase Returns and Allowances ..		5,880
07/10	Accounts Payable (\$54,000 X 98%)	52,920	
	 Cash		52,920

BRIEF EXERCISE 13-4

11/01/14	Cash	40,000	
	 Notes Payable		40,000
12/31/14	Interest Expense	600	
	 Interest Payable		600
	 (\$40,000 X 9% X 2/12)		
02/01/15	Notes Payable	40,000	
	 Interest Payable	600	
	 Interest Expense	300	
	 Cash		40,900

BRIEF EXERCISE 13-5

01/01/15	Interest Payable	600	
	 Interest Expense		600
02/01/15	Notes Payable	40,000	
	 Interest Expense	900	
	 Cash		40,900

BRIEF EXERCISE 13-6

11/01/14	Cash	60,000	
	Notes Payable		60,000
12/31/14	Interest Expense	900	
	Notes Payable		900
	(\$1,350 X 2/3)		
02/01/15	Interest Expense	450	
	Notes Payable		450
	Notes Payable	61,350	
	Cash.....		61,350

BRIEF EXERCISE 13-7

Accounts Receivable	41,810	
Sales Revenue.....		37,000
HST Payable (\$37,000 X 13%).....		4,810

BRIEF EXERCISE 13-8

Purchases.....	29,400	
GST Receivable (\$29,400 X 5%).....	1,470	
Accounts Payable		30,870
Accounts Receivable	47,250	
Sales Revenue.....		45,000
GST Payable		2,250
GST Payable	2,250	
Cash		780
GST Receivable.....		1,470

BRIEF EXERCISE 13-9

Income Tax Expense	12,800	
Cash (\$3,200 X 4).....		12,800

Income Tax Expense (\$20,000 – \$12,800)	7,200	
Income Tax Payable		7,200

At year end, the company would report Income Tax Payable of \$7,200 in current liabilities.

BRIEF EXERCISE 13-10

Income Tax Receivable	2,600	
Income Tax Expense		2,600
(\$12,800 – \$10,200)		

At year end, the company would report Income Tax Receivable of \$2,600 in current assets.

BRIEF EXERCISE 13-11

- (a) Under IFRS, the \$600,000 debt is reclassified as current because the long-term debt agreement is violated and the liability becomes payable on demand. It should be noted that under IFRS, the debt is reclassified as current, even if the lender agrees between the date of the statement of financial position and the date the financial statements are released that it will not demand repayment because of the violation.
- (b) Under ASPE, the \$600,000 debt is reclassified as current unless the creditor waives in writing the covenant (agreement) requirements, or the violation has been cured within the grace period that is usually given in these agreements and it is likely that the company will not violate the covenant requirements within a year from the balance sheet date.

BRIEF EXERCISE 13-12

- (a) Under IFRS, since the debt is due within 12 months from the reporting date, it is classified as a current liability. This classification holds even if long-term refinancing has been completed before the financial statements are released. The only exception accepted for continuing long-term classification is if, at the balance sheet date, the entity expects to refinance it or roll it over under an existing agreement for at least 12 months and the decision is solely at its discretion.
- (b) Under IFRS, the whole \$500,000 of maturing debt would still be classified as a current obligation at December 31, 2014. The international standard has a stringent requirement that the agreement must be firm at the date of the statement of financial position in order to qualify for classification as long-term. (This assumes Burr had not entered into a long-term agreement prior to the statement of financial position date.)
- (c) For part (a), under ASPE, the debt would be classified as a long-term liability. If there is irrefutable evidence by the time the financial statements are completed and released that the debt has been or will be converted into a long-term obligation, ASPE allows currently maturing debt to be classified as long-term on the balance sheet. In this case, the debt was refinanced before the financial statements were completed and released.

For part (b), under ASPE, the debt would be classified as a current liability since there was not irrefutable evidence by the time the financial statements were completed that the debt has been or will be converted into a long-term obligation. (This assumes Burr had not entered into a long-term agreement prior to the release of the financial statements.) In addition, since repayment occurred before funds were obtained through long-term financing, the repayment used existing current assets.

BRIEF EXERCISE 13-13

Salaries and Wages Expense	23,000	
Employee Income Tax Deductions Payable		3,426
CPP Contributions Payable		990
EI Premiums Payable		920
Health Insurance Premiums Payable		250
Cash		17,414

BRIEF EXERCISE 13-14

(a)

Payroll Tax Expense	2,278	
EI Premiums Payable (\$920 X 1.4)		1,288
CPP Contributions Payable		990

(b)

Employee Income Tax Deductions Payable	3,426	
CPP Contributions Payable (\$990 X 2)	1,980	
EI Premiums Payable (\$920 + \$1,288)	2,208	
Cash		7,614

BRIEF EXERCISE 13-15

Salaries and Wages Expense	30,000	
Vacation Wages Payable		30,000
(30 X 2 X \$500)		

BRIEF EXERCISE 13-16**December 1, 2014:**

Employee Benefit Expense*	11,952	
 Parental Leave Benefits Payable		11,952

* Salary for 17 weeks (\$74,000 ÷ 52 X 17)	\$24,192	
Less: employment insurance		
 payments (\$720/week X 17 weeks)	<u>(12,240)</u>	
Employee Benefit Expense	\$11,952	

For each of the 4 weeks in December, 2014, Laurin Corporation will pay Ruzbeh Awad a top up amount and record the payments as follows:

Parental Leave Benefits Payable	703.08	
 Cash		703.08
(\$74,000 ÷ 52 weeks) = \$1,423.08 – \$720.00 = \$703.08		

BRIEF EXERCISE 13-17

12/31/14	Bonus Expense	350,000	
	 Bonus Payable		350,000
2/15/15	Bonus Payable	350,000	
	 Cash		350,000

BRIEF EXERCISE 13-18

Drilling Platform	500,249	
 Asset Retirement Obligation		500,249
 (\$1,000,000 X .50025)		

Using a financial calculator:

PV	?	Yields \$ 500,248.97
I	8%	
N	9	
PMT	0	
FV	\$ (1,000,000)	
Type	0	

BRIEF EXERCISE 13-19

(a) IFRS

Depreciation Expense	1,166,694	
 Accumulated Depreciation –		1,166,694
 Drilling Platform		
 [(\$10,000,000 + \$500,249) ÷ 9 years]		

Interest Expense	40,020	
 Asset Retirement Obligation		40,020
 (\$500,249 X 8%)		

(b) ASPE

Depreciation Expense	1,166,694	
 Accumulated Depreciation–		1,166,694
 Drilling Platform		
 [(\$10,000,000 + \$500,249) ÷ 9 years]		

Accretion Expense	40,020	
 Asset Retirement Obligation		40,020
 (\$500,249 X 8%)		

BRIEF EXERCISE 13-20**(a) IFRS**

Inventory	54,027	
 Asset Retirement Obligation		54,027

(b) ASPE

Drilling Platform	54,027	
 Asset Retirement Obligation		54,027

BRIEF EXERCISE 13-21

2014	Cash, A/R, etc.....	2,500,000	
	 Sales Revenue—Product.....		2,500,000
2014	Warranty Expense.....	63,000	
	 Cash, Inventory, etc.....		63,000
12/31/14	Warranty Expense.....	420,000	
	 Warranty Liability.....		420,000

BRIEF EXERCISE 13-22

2014	Cash, A/R, etc.....	2,500,000	
	 Sales Revenue—Product.....		1,900,000
	 Unearned Warranty Revenue ..		600,000
2014	Warranty Expense.....	63,000	
	 Accounts Payable,		
	 Salaries and Wages		63,000
	 Payable, etc.....		
12/31/14	Unearned Warranty Revenue	150,000	
	 Warranty Revenue		150,000
	 \$600,000 X 25%		

BRIEF EXERCISE 13-23

Note that this warranty contract is a separate service and should be accounted for using the revenue approach, which is the preferred method under both IFRS and ASPE for multiple deliverables (bundled sales).

(a)	Cash	1,980,000	
	 Unearned Warranty Revenue		1,980,000
	 (20,000 X \$99)		
(b)	Warranty Expense	180,000	
	 Cash, Inventory, etc.		180,000
(c)	Unearned Warranty Revenue	330,000	
	 Warranty Revenue		330,000
	 [\$1,980,000 X (\$180,000/\$1,080,000*)]		
	 * \$180,000 + \$900,000 = \$1,080,000		

BRIEF EXERCISE 13-24**(a) IFRS**

Inventory of Premiums	250,000	
Cash		250,000
100,000 X \$2.50		

Cash, A/R, etc.	4,000,000	
Sales Revenue		3,600,000
Unearned Premium Revenue		400,000*
* 1,000,000 X \$4.00 X 10%		

Cash.	80,000**	
Premium Expense	120,000	
Inventory of Premiums		200,000***
** 240,000/3 X \$1.00		
*** 240,000/3 X \$2.50		

Unearned Premium Revenue	320,000	
Sales Revenue		320,000
240,000/(1,000,000 X 30%) X \$400,000		

(b) ASPE

Inventory of Premiums	250,000	
Cash		250,000
100,000 X \$2.50		

Cash, A/R, etc.	4,000,000	
Sales Revenue		4,000,000

Cash.	80,000**	
Premium Expense	120,000	
Inventory of Premiums		200,000***
** 240,000/3 X \$1.00		
*** 240,000/3 X \$2.50		

Premium Expense	30,000	
Premium Liability		30,000
[(1,000,000 X 30%) – 240,000] / 3 X (\$2.50 - \$1.00)		

BRIEF EXERCISE 13-25

(a) **Litigation Expense 700,000**
Litigation Liability 700,000

(b) **Litigation Expense 700,000**
Litigation Liability 700,000

(c) **No entry is necessary. The loss is not accrued because it is not probable that a liability has been incurred at 12/31/14.**

(d) **ASPE where Litigation Liability is likely:**

Litigation Expense 700,000
Litigation Liability 700,000

ASPE where Litigation Liability is not likely:

No entry is necessary. The loss is not accrued because it is not likely that a liability has been incurred at 12/31/14.

BRIEF EXERCISE 13-26**(a)**

Under IFRS, Siddle should record a loss since it is probable that a liability has been incurred, and the amount is reliably measurable. The amount should be measured at the probability-weighted expected value of the loss. Assuming that a payout of \$100,000 and a payout of \$250,000 are equally probable, a loss in the amount of \$175,000 is recorded.

Litigation Expense	175,000	
Litigation Liability		175,000

The \$100,000 self-insurance allowance can be achieved by an appropriation of retained earnings or by note disclosure.

(b)

Under ASPE, Siddle should record a loss since it is likely that a liability has been incurred, and the amount can be reasonably estimated. The amount should be measured at the best estimate in the range of possible outcomes. If no particular estimate is better than another, the bottom of the range is recognized, and the amount of the remaining exposure to possible loss is disclosed in the notes. Assuming that a payout of \$100,000 and a payout of \$250,000 are equally likely, a loss in the amount of \$100,000 is recorded, and the remaining exposure of \$150,000 is disclosed in the notes.

Litigation Expense	100,000	
Litigation Liability		100,000

The \$100,000 self-insurance allowance can be achieved by an appropriation of retained earnings or by note disclosure.

BRIEF EXERCISE 13-27

<u>Ratio</u>	<u>2016</u>	<u>2015</u>	<u>2014</u>
Current Ratio	2.17	2.11	2.00
Quick Ratio	0.54	0.59	0.66
Days Payables Outstanding	39.54	34.98	N/A

Current Ratio = Current Assets / Current Liabilities

2014 : \$7,300 / \$3,650 = 2.00

2015 : \$7,800 / \$3,700 = 2.11

2016 : \$8,250 / \$3,800 = 2.17

Quick Ratio = Quick Assets / Current Liabilities

2014 : (\$600 + \$500 + \$1,300) / \$3,650 = 0.66

2015 : (\$700 + \$500 + \$1,000) / \$3,700 = 0.59

2016 : (\$650 + \$500 + \$900) / \$3,800 = 0.54

Days Payables Outstanding

= $\frac{\text{Average Trade Accounts Payable}}{\text{Average Daily Cost of Goods Sold}}$

2015 : $\frac{(\$1,700 + \$1,750) / 2}{(18,000 / 365)} = 34.98$

2016 : $\frac{(\$1,550 + \$1,700) / 2}{(15,000 / 365)} = 39.54$

BRIEF EXERCISE 13-27 (Continued)

The company shows a positive trend in the current ratio. However, the quick ratio shows deterioration in the quality of the current assets. The two ratios combined show that the increasing liquidity in the current ratio is created from less liquid assets such as inventory and prepaid expenses. These current assets are less liquid than other current assets.

The days payables outstanding ratio shows an increasing time period for the company to pay off its current liabilities from approximately 35 days in 2015 to almost 40 days in 2016. If the company's creditors normally have credit terms of 30 days, this shows a disturbing trend, especially when combined with the deterioration in the quick ratio.

SOLUTIONS TO EXERCISES

EXERCISE 13-1 (10-15 minutes)

(a) Classifications on balance sheet prepared under ASPE:

- 1. Current liability; financial liability.**
- 2. Current asset.**
- 3. Current liability or long-term liability depending on term of warranty; not a financial liability.**
- 4. Current liability; financial liability. A company would have an obligation to pay cash to the bank for any overdraft and this would result from the contractual agreement with the bank.**
- 5. Current liability; not a financial liability if this refers to income tax withholdings, CPP and EI. This is a financial liability if it refers to other withholdings of a contractual nature with employees (union dues, for example).**
- 6. Current liability; financial liability.**
- 7. Current or noncurrent liability depending upon the time involved; not a financial liability (if deposit will be returned then it would be a financial liability).**
- 8. Current liability; not a financial liability.**
- 9. Current liability; not a financial liability.**
- 10. Current liability; not a financial liability.**
- 11. Current liability; financial liability.**
- 12. Note disclosure if assume not reasonably estimable and/or likelihood of confirming future event cannot be determined. If assume likely and reasonably estimable then current or noncurrent liability depending upon the time involved; not a financial liability. A personal injury suit that requires you to pay is a result of a court order, not a contract – either written or implied – between two parties.**
- 13. Current liability; financial liability.**
- 14. Current liability; financial liability.**

EXERCISE 13-1 (Continued)

- 15. Note disclosure; not a financial liability. Dividends in arrears have not been booked – so it cannot be a financial liability. It becomes a financial liability only when declared by the company. The contractual arrangement between a company and its preferred shareholders is that they are entitled to a dividend every year before the common get any distributions, but they must be declared to be a liability at all.**
- 16. Separate presentation in either current or long-term liability section; financial liability.**
- 17. Current liability; not a financial liability.**
- 18. Current or noncurrent liability depending upon the time involved; not a financial liability.**
- 19. Current liability; financial liability.**

(b) Changes if the balance sheet was prepared under IFRS:

- (12) Under existing IAS 37: Note disclosure unless the likelihood of needing future resources to settle the contingent liability is remote. Note disclosure also required if amount not reliably measurable (however, the standard indicates that it is only in very rare circumstances that this would be the case). Under proposed amendments to IAS 37: It must first be determined whether the obligation exists at the reporting date. Liabilities can arise only from unconditional (or non-contingent) obligations. Uncertainty about the amounts that might be payable in the future is taken into account in the measurement of the liability, not its existence. If a liability is recognized, it is measured, and it is the measurement that takes into account the uncertainties that exist.**

EXERCISE 13-2 (20-25 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		1,000
		(\$50,000 X 8% X 3/12)		
	Dec. 31	Interest Expense	1,500	
		Notes Payable		1,500
		[(\$81,000 – \$75,000) X 3/12]		
(c)	(1)	Note payable	\$50,000	
		Interest payable	<u>1,000</u>	
			<u>\$51,000</u>	
	(2)	Note payable	\$75,000	
		Interest accrued	<u>1,500</u>	
			<u>\$76,500</u>	
(d)	Oct. 1/15	Interest Expense *	3,000	
		Interest Payable	1,000	
		Notes Payable	50,000	
		Cash		54,000
		*(\$50,000 X 8% X 9/12)		
	Oct. 1/15	Interest Expense	4,500	
		Notes Payable		4,500
		[(\$81,000 – \$75,000) X 9/12]		
		Notes Payable	81,000	
		Cash		81,000

EXERCISE 13-2 (Continued)

(e)			
<u>Orion Note:</u>			
Jan. 1	Interest Payable.....	1,000	
	Interest Expense		1,000
Oct. 1	Interest Expense	4,000	
	Notes Payable.....	50,000	
	Cash		54,000

Bank Note:

The use of reversing entries is more efficient for the interest-bearing note. In this case, the bookkeeping staff will debit interest expense for the full 12 months when the note is paid (that is, for the difference between the note's carrying amount and the cash paid) and, in combination with the reversing entry, the expense in 2015 will be correct. With the non-interest bearing note, there is no need to reverse the interest. When the note is paid at maturity, the difference between the note's carrying amount and the amount paid is all charged – correctly – to interest expense.

If reversing entry used:

Jan. 1	Notes Payable.....	1,500	
	Interest Expense		1,500
Oct. 1	Interest Expense	6,000	
	Notes Payable.....	75,000	
	Cash		81,000

If reversing entry not used:

Oct. 1	Interest Expense	4,500	
	Note Payable.....	76,500	
	Cash		81,000

EXERCISE 13-3 (15-20 minutes)

(a)	Cash	894,000	
	Liability for Returnable Containers...		894,000
	Liability for Returnable Containers.....	705,400	
	Cash		705,400
	Liability for Returnable Containers.....	55,000	
	Sales Revenue.....		55,000
	(\$170,000 – \$115,000)		

(b)	<u>Liability for Returnable Containers</u>		
		\$650,000	12/31/13 liability
		894,000	2014 deliveries
2014 returns	\$705,400		
2012 expired deposits	<u>55,000</u>	<u>(760,400)</u>	
		<u>\$783,600</u>	12/31/14 liability

- (c)** The classification of this liability as current or long-term depends upon the length of the company's operating cycle. If the company's operating cycle is one year or less, then the portion of the liability that is expected to be settled within one year is classified as current. The remaining deposits would be classified as long-term. If the company's operating cycle is between one year and two years, the portion of the liability that is expected to be settled within one operating cycle is classified as current. If the company's operating cycle is two years or more, the entire liability (\$783,600) is classified as current.

EXERCISE 13-4 (20-30 minutes)**(a) Province of Ontario**

March 1	Rent Expense	5,500	
	HST Receivable (\$5,500 X 13%)	715	
	Cash		6,215
3	Accounts Receivable—Marcus	22,600	
	Sales Revenue		20,000
	HST Payable (\$20,000 X 13%)...		2,600
	Cost of Goods Sold	11,000	
	Inventory		11,000
5	Sales Returns and Allowances	500	
	HST Payable (\$500 X 13%)	65	
	Accounts Receivable—Marcus		565
7	Inventory	14,000	
	HST Receivable (\$14,000 X 13%) ...	1,820	
	Accounts Payable—Tinney		15,820
12	Furniture and Fixtures	600	
	HST Receivable (\$600 X 13%)	78	
	Cash		678
31	HST Payable (\$2,600 – \$65)	2,535	
	HST Receivable	78	
	HST Receivable		2,613
	(\$715 + \$1,820 + \$78)		

EXERCISE 13-4 (Continued)**(b) Province of Alberta**

March 1	Rent Expense	5,500	
	GST Receivable (\$5,500 X 5%).....	275	
	Cash		5,775
3	Accounts Receivable—Marcus	21,000	
	Sales Revenue.....		20,000
	GST Payable (\$20,000 X 5%)		1,000
	Cost of Goods Sold.....	11,000	
	Inventory.....		11,000
5	Sales Returns and Allowances.....	500	
	GST Payable (\$500 X 5%).....	25	
	Accounts Receivable—Marcus ..		525
7	Inventory	14,000	
	GST Receivable (\$14,000 X 5%).....	700	
	Accounts Payable—Tinney		14,700
12	Furniture and Fixtures	600	
	GST Receivable (\$600 X 5%)	30	
	Cash		630
31	GST Payable (\$1,000 – \$25)	975	
	GST Receivable	30	
	GST Receivable		
	(\$275 + \$700 + \$30).....		1,005

EXERCISE 13-4 (Continued)**(c)**

March 1	Rent Expense	5,500	
	GST Receivable (\$5,500 X 5%)	275	
	Cash		5,775
3	Accounts Receivable—Marcus	23,100	
	Sales Revenue.....		20,000
	GST Payable (\$20,000 X 5%) ...		1,000
	PST Payable		2,100
	[((\$20,000 X 1.05) X 10%]		
	Cost of Goods Sold.....	11,000	
	Inventory.....		11,000
5	Sales Returns and Allowances	500	
	GST Payable (\$500 X 5%)	25	
	PST Payable [(\$500 X 1.05) X 10%] ..	53	
	Accounts Receivab.—Marcus .		578
7	Inventory.....	14,000	
	GST Receivable (\$14,000 X 5%)	700	
	Accounts Payable—Tinney		14,700
12	Furniture and Fixtures (\$600+\$63*)..	663	
	GST Receivable (\$600 X 5%)	30	
	Cash		693
	* (\$600 X 1.05) X 10% = \$63		
31	GST Payable (\$1,000 – \$25)	975	
	GST Receivable	30	
	GST Receivable		
	(\$275 + \$700 + \$30).....		1,005

EXERCISE 13-5 (15-20 minutes)

(a)	Mar. 31	Income Tax Expense.....	8,100	
		Cash.....		8,100
	June 1	Cash.....	11,250	
		Income Tax Receivable.....		11,250
	June 30	Income Tax Expense.....	8,100	
		Cash.....		8,100
	Sep. 30	Income Tax Expense.....	8,100	
		Cash.....		8,100
	Dec. 31	Income Tax Expense.....	8,100	
		Cash.....		8,100
	Dec. 31	Income Tax Expense.....	5,400	
		Income Tax Payable.....		5,400
		Estimated income tax	\$37,800	
		Income tax instalments paid		
		(\$8,100 X 4)	<u>(32,400)</u>	
		Income tax payable	<u>\$ 5,400</u>	

(b) The income tax payable will be shown as a current liability.

(c)	June 1	Cash.....	2,750	
		Retained Earnings.....	8,500	
		Income Tax Receivable.....		11,250

The error relates to a prior period and should be treated as an adjustment to opening retained earnings on the statement of retained earnings or statement of changes in equity.

EXERCISE 13-6 (30-35 minutes)

#	Assets	Liabilities	Owners' 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	NE	NE	NE	NE
11	NE	I	D	D
12	NE	I	D	D
13	NE	I	D	D
14	D	D	NE	NE
15	I	I	I	I
16	D	NE	D	D
17	NE	D	I	I
18	NE	I	D	D
19	I	I	NE	NE
20	I	D	I	I

EXERCISE 13-7 (10-12 minutes)**(a)**

**Hornsby Corporation
Partial Balance Sheet
December 31, 2014**

Current liabilities:

Notes payable (Note 1)	\$250,000
------------------------	-----------

Long-term debt:

Notes payable refinanced in February 2015 (Note 1)	950,000
---	---------

Note 1: Short-term debt refinanced

As of December 31, 2014, the company had notes payable totalling \$1,200,000 due on February 2, 2015. These notes were refinanced on their due date to the extent of \$950,000 received from the issuance of common shares on January 21, 2015. The balance of \$250,000 was liquidated using current assets.

OR**Current liabilities:**

Notes payable (Note 1)	\$250,000
------------------------	-----------

Long-term debt:

Short-term debt expected to be refinanced (Note 1)	950,000
---	---------

(Same Note as above.)

EXERCISE 13-7 (Continued)

- (b) Under IFRS, since the debt is due within 12 months from the reporting date, the whole amount (\$1.2 million) is classified as a current liability. This classification holds even if a long-term refinancing has been completed before the financial statements are released. The only exception accepted for continuing long-term classification is if, at the balance sheet date, the entity expects to refinance it or roll it over under an existing agreement for at least 12 months and the decision is solely at its discretion. The international standard has a stringent requirement that the agreement must be firm at the balance sheet date.
- (c) The current ratio is calculated as current assets/current liabilities. If Hornsby follows ASPE, current liabilities would include \$250,000 related to the short-term notes payable. If Hornsby follows IFRS, current liabilities would include \$1.2 million related to the short-term notes payable. Therefore, the current ratio would appear higher if Hornsby follows ASPE. A creditor would want to assess the company's liquidity and solvency, and should be aware that classification of the short-term notes payable on the balance sheet has a significant impact on key ratios including the current ratio. The creditor should refer to all information in the financial statements, including notes to the financial statements, to determine the financial position of the company, especially when comparing the company's performance to that of another company with financial statements prepared under a different standard.

EXERCISE 13-8 (10-15 minutes)

Zimmer Corporation
Partial Balance Sheet
December 31, 2014

Current liabilities:

Notes payable (Note 1)	\$4,480,000
------------------------	-------------

Long-term debt:

Notes payable expected to be refinanced in 2015 (Note 1)	3,420,000
---	-----------

Note 1.

Under a financing agreement with Provincial Bank the company may borrow up to 60% of the gross amount of its accounts receivable at an interest cost of 1% above the prime rate. The company intends to issue notes maturing in 2016 to replace \$3,420,000 of short-term, 15%, notes due periodically in 2015. Because the amount that can be borrowed may range from \$3,420,000* to \$4,200,000**, only \$3,420,000 of the \$7,900,000 of currently maturing debt has been reclassified as long-term debt.

Expected range of receivables:

* low in May: $\$5,700,000 \times 60\% = \$3,420,000$

** high in October: $\$7,000,000 \times 60\% = \$4,200,000$

- (b) Under IFRS, since the debt is due within 12 months from the reporting date, the whole amount (\$7.9 million) is classified as a current liability. This classification holds even if a long-term refinancing has been completed before the financial statements are released. The only exception accepted for continuing long-term classification is if, at the balance sheet date, the entity expects to refinance it or roll it over under an existing agreement for at least 12 months and the decision is solely at its discretion. The international standard has a stringent requirement that the agreement must be firm at the balance sheet date.

EXERCISE 13-9 (15-20 minutes)

- (a) **Salaries and Wages Expense** **485,000**
Employee Income Tax Deductions
 Payable..... **85,000**
 EI Premiums Payable* **6,680**
 CPP Contributions Payable** **18,068**
 Union Dues Payable..... **8,000**
 Cash **367,252**
 ***\$365,000 X 1.83% = \$6,315**
 ****\$365,000 X 4.95% = \$18,068**
- Payroll Tax Expense** **27,419**
 EI Premiums Payable **9,351**
 \$365,000 X 2.562%
 CPP Contributions Payable **18,068**
 (See previous calculation)
- (b) **Employee Income Tax Deductions**
 Payable **85,000**
 EI Premiums Payable (\$6,680 + \$9,351).... **16,031**
 CPP Contributions Payable **36,136**
 (\$18,068 + \$18,068)
 Cash **137,167**
- Union Dues Payable**..... **8,000**
 Cash **8,000**
- (c) **Salaries and wages for September 2014** **\$485,000**
 Payroll tax expense **27,419**
 Total payroll cost for September 2014 **\$512,419**
 Cost per dollar of salaries and wages = (\$512,419 ÷
 \$485,000) = \$1.057
- (d) **The company may have additional employee-related costs such as Workplace Safety and Insurance Board (WSIB) coverage, health taxes, health and disability insurance, pension benefits, compensated absences (paid vacation, maternity/paternity leave, sick pay) and indirect costs such as a human resources department.**

EXERCISE 13-10 (25-30 minutes)

- (a) **To accrue the expense and liability for vacation entitlement:**
-

2013	Salaries and Wages Expense	7,200	
	Vacation Wages Payable		7,200(1)

2014	Salaries and Wages Expense	7,920	
	Vacation Wages Payable		7,920(2)

	Salaries and Wages Expense	648	
	Vacation Wages Payable	6,480(3)	
	Cash		7,128(4)

- | | | |
|-----|--|---------|
| (1) | 9 employees X \$10.00/hr. X 8 hrs./day X 10 days = | \$7,200 |
| (2) | 9 employees X \$11.00/hr. X 8 hrs./day X 10 days = | \$7,920 |
| (3) | 9 employees X \$10.00/hr. X 8 hrs./day X 9 days = | \$6,480 |
| (4) | 9 employees X \$11.00/hr. X 8 hrs./day X 9 days = | \$7,128 |

NOTE: Vacation days are paid at the employee's current wage.

- (b) **To accrue the expense and liability for sick days:**
-

2013	Salaries and Wages Expense	4,320	
	Sick Pay Wages Payable		4,320(1)

To record payment for compensated time when used by employees:

	Sick Pay Wages Payable	2,880(2)	
	Cash		2,880

2014	Salaries and Wages Expense	4,752	
	Sick Pay Wages Payable		4,752 (3)

EXERCISE 13-10 (Continued)

2014	Salaries and Wages Expense	144	
	Sick Pay Wages Payable	3,816(4)	
	Cash		3,960(5)

(1)	9 employees X \$10.00/hr. X 8 hrs./day X 6 days =	<u>\$4,320</u>
(2)	9 employees X \$10.00/hr. X 8 hrs./day X 4 days =	<u>\$2,880</u>
(3)	9 employees X \$11.00/hr. X 8 hrs./day X 6 days =	<u>\$4,752</u>
(4)	9 employees X \$10.00/hr. X 8 hrs./day X (6–4) days =	\$1,440
	9 employees X \$11.00/hr. X 8 hrs./day X (5–2) days =	+ <u>\$2,376</u>
		<u>\$3,816</u>

(5)	9 employees X \$11.00/hr. X 8 hrs./day X 5 days =	<u>\$3,960</u>
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NOTE: Sick days are paid at the employee's current wage.

(c) Accrued liability at year-end:

	2013		2014	
	<u>Vacation Wages Payable</u>	<u>Sick Pay Wages Payable</u>	<u>Vacation Wages Payable</u>	<u>Sick Pay Wages Payable</u>
Jan. 1 balance	\$ 0	\$ 0	\$7,200	\$1,440
+ accrued	7,200	4,320	7,920	4,752
– paid	<u>(0)</u>	<u>(2,880)</u>	<u>(6,480)</u>	<u>(3,816)</u>
Dec. 31 balance	<u>\$7,200(1)</u>	<u>\$1,440(2)</u>	<u>\$8,640(3)</u>	<u>\$2,376(4)</u>

(1)	9 emp. X \$10.00/hr. X 8 hrs./day X 10 days =	<u>\$7,200</u>
(2)	9 emp. X \$10.00/hr. X 8 hrs./day X (6–4) days =	<u>\$1,440</u>
(3)	9 emp. X \$10.00/hr. X 8 hrs./day X (10–9) days =	\$ 720
	9 emp. X \$11.00/hr. X 8 hrs./day X 10 days =	+ <u>7,920</u>
		<u>\$8,640</u>
(4)	9 emp. X \$11.00/hr. X 8 hrs./day X (6 + 6 – 4 – 5) days	<u>\$2,376</u>

EXERCISE 13-10 (Continued)

- (d) Since the sick days entitlement does not accumulate, the company would not accrue unused sick days. Unused sick days would expire. Paid sick days taken by employees during the year would be debited to Salaries and Wages Expense as taken at the wage rate in effect in that year.

To record payment for compensated time when used by employees:

2013	Salaries and Wages Expense	2,880(1)	
	Cash		2,880
2014	Salaries and Wages Expense	3,960	
	Cash		3,960 (2)
(1)	9 employees X \$10.00/hr. X 8 hrs./day X 4 days =		<u>\$2,880</u>
(2)	9 employees X \$11.00/hr. X 8 hrs./day X 5 days =		<u>\$3,960</u>

The accrued liability at year-end would be the same as part (c) for vacation wages payable, but no accrual would be required for sick days.

Vacation Wages Payable (2013) = \$7,200

Vacation Wages Payable (2014) = \$8,640

EXERCISE 13-11 (25-30 minutes)**(a)****2013 To accrue the expense and liability for vacations:**

Salaries and Wages Expense	7,740	(1)	
Vacation Wages Payable			7,740

To record vacation time paid:**No entry.****2014 To accrue the expense and liability for vacations:**

Salaries and Wages Expense	8,352	(2)	
Vacation Wages Payable			8,352

To record vacation time paid:

Salaries and Wages Expense	162		
Vacation Wages Payable	6,966	(3)	
Cash			7,128 (4)

- (1) 9 employees X \$10.75/hr. X 8 hrs./day X 10 days = \$7,740
 (2) 9 employees X \$11.60/hr. X 8 hrs./day X 10 days = \$8,352
 (3) 9 employees X \$10.75/hr. X 8 hrs./day X 9 days = \$6,966
 (4) 9 employees X \$11.00/hr. X 8 hrs./day X 9 days = \$7,128

(b)**2013 To record sick time paid:**

Salaries and Wages Expense	2,880	(1)	
Cash			2,880

2014 To record sick time paid:

Salaries and Wages Expense	3,960	(2)	
Cash			3,960

- (1) 9 employees X \$10.00/hr. X 8 hrs./day X 4 days = \$2,880
 (2) 9 employees X \$11.00/hr. X 8 hrs./day X 5 days = \$3,960

EXERCISE 13-11 (Continued)**(c) Accrued liability at year-end (vacation pay only):**

	<u>2013</u>	<u>2014</u>
Jan. 1 balance	\$ 0	\$7,740
+ accrued	7,740	8,352
– paid	<u>(0)</u>	<u>(6,966)</u>
Dec. 31 balance	<u>\$7,740(1)</u>	<u>\$9,126(2)</u>

(1) 9 employees X \$10.75/hr. X 8 hrs./day X 10 days = \$7,740

(2) 9 employees X \$10.75/hr. X 8 hrs./day X 1 day = \$ 774
 9 employees X \$11.60/hr. X 8 hrs./day X 10 days = 8,352
\$9,126

EXERCISE 13-12 (25-30 minutes)**(a) October 29, 2014*:**

Employee Benefit Expense*	36,810	
 Parental Leave Benefits Payable		36,810

The expense and liability are recognized when the event that obligates the entity occurs. For maternity and parental leave, the application for leave is the event that obligates the corporation (*CICA Handbook for Private Enterprises* section 3461). The notification in June is not considered actual application for leave.

* Salary for 12 months	\$54,000
Less: employment insurance	
payments (\$720/week X 52 weeks)	(37,440)
Salary for 6 months at 75%	
(\$54,000 X 6/12 X 75%)	<u>20,250</u>
Employee Benefit Expense	<u>\$36,810</u>

For each of the 9 weeks from October 29, 2014 to December 31, 2014, Goldwing Corporation will pay Zeinab Jolan a top up amount and record the payments as follows:

Parental Leave Benefits Payable	318	
 Cash		318
(\$54,000 – \$37,440) ÷ 52 weeks = \$318		

(b) Parental Leave Benefits Payable	20,708*	
 Cash		20,708

*Top up for one year (\$54,000 – \$37,440)	\$16,560
Less portion used in 2014 (9 weeks X \$318)	(2,862)
Remaining 9 weeks at 75% of full pay	
(\$20,250 X 9/26)	<u>7,010</u>
Benefits paid during 2015	<u>\$20,708</u>

EXERCISE 13-12 (Continued)

**(c) Parental Leave Benefits Payable at December 31, 2014 =
\$36,810 – (9 weeks X \$318) = \$33,948**

**Parental Leave Benefits Payable at December 31, 2015 =
\$33,948 – \$20,708 = \$13,240**

The parental leave benefits payable balance at December 31, 2014 will have both a current and long-term portion. The amount payable within the coming year, \$20,708, will be shown as a current liability, whereas the remaining \$13,240, which will be payable in 2016, will be shown as a long-term liability.

On the December 31, 2015 balance sheet, the remaining amount of \$13,240 will be shown as a current liability.

EXERCISE 13-13 (15-20 minutes)**(a)**

Justin Corp.
Income Statement
For the Year Ended December 31, 2014

Sales revenue		\$10,000,000
Cost of goods sold		<u>7,000,000</u>
Gross profit		3,000,000
Administrative and selling expenses	\$1,000,000	
Profit-sharing bonus to employees	<u>245,614</u>	<u>1,245,614</u>
Income before income tax		1,754,386
Income tax (30%)		<u>526,316</u>
Net income		<u>\$ 1,228,070</u>

Calculation of bonus and tax:

$$\begin{aligned}
 T &= .30 (\$3,000,000 - \$1,000,000 - B) \\
 B &= .20 (\$2,000,000 - B - T) \\
 B &= .20 [\$2,000,000 - B - .30 (\$2,000,000 - B)] \\
 B &= .20 (\$2,000,000 - B - \$600,000 + .30B) \\
 B &= .20 (\$1,400,000 - .70B) \\
 B &= \$280,000 - .14B \\
 1.14B &= \$280,000 \\
 \text{Bonus} &= \$245,614.04 \\
 T &= .30 (\$2,000,000 - \$245,614.04) \\
 T &= .30 (\$1,754,385.96) \\
 \text{Tax} &= \$526,315.79
 \end{aligned}$$

(b) Bonus Expense	245,614	
Bonus Payable.....		245,614

EXERCISE 13-14 (20-25 minutes)

(a)	January 1, 2014		
Drilling Platform		5,460,000	
Cash			5,460,000
Drilling Platform		419,063	
Asset Retirement Obligation			419,063
(PV of \$950,000 using $i=8\%$ and $n=6$) X 70%			
\$950,000 X .63017 X 70%			
(b)	December 31, 2014		
Depreciation Expense		979,844	
Accumulated Depreciation –			
Drilling Platform			979,844
(\$5,460,000 + \$419,063) ÷ 6			
Interest Expense		33,525	
Asset Retirement Obligation			33,525
\$419,063 X 8%			
Inventory		32,328	
Asset Retirement Obligation			32,328
(c)	December 31, 2015		
Depreciation Expense		979,844	
Accumulated Depreciation –			
Drilling Platform			979,844
(\$5,460,000 + \$419,063) ÷ 6			
Interest Expense		38,793	
Asset Retirement Obligation			38,793
(\$419,063 + \$33,525 + \$32,328) X 8%			
Inventory		34,914	
Asset Retirement Obligation			34,914

EXERCISE 13-14 (Continued)

(d)	December 31, 2019	
Asset Retirement Obligation	950,000	
Gain on Settlement of Asset Retirement Obligation		28,000
Cash		922,000

(e)	January 1, 2014	
Drilling Platform	5,460,000	
Cash		5,460,000

Drilling Platform	419,063	
Asset Retirement Obligation		419,063
(PV of \$950,000 using $i=8\%$ and $n=6$) X 70%		
\$950,000 X .63017 X 70%		

	December 31, 2014	
Depreciation Expense	979,844	
Accumulated Depreciation – Drilling Platform		979,844
$(\\$5,460,000 + \\$419,063) \div 6$		

Accretion Expense	33,525	
Asset Retirement Obligation		33,525
$\\$419,063 \times 8\%$		

Drilling Platform	32,328	
Asset Retirement Obligation		32,328

	December 31, 2015	
Depreciation Expense	986,310	
Accumulated Depreciation – Drilling Platform		986,310
$(\\$5,460,000 + \\$419,063) \div 6 + \\$32,328 \div 5$		

Accretion Expense	38,793	
Asset Retirement Obligation		38,793
$(\\$419,063 + \\$33,525 + \\$32,328) \times 8\%$		

EXERCISE 13-14 (Continued)

Drilling Platform	34,914	
 Asset Retirement Obligation		34,914
December 31, 2019		
Asset Retirement Obligation	950,000	
 Gain on Settlement of Asset		
 Retirement Obligation		28,000
Cash		922,000

EXERCISE 13-15 (25-35 minutes)**(a)**

Present value of the asset retirement obligation
= \$75,000 X .55839 = \$41,879

Using a financial calculator:

PV	?	Yields \$ 41,879.61
I	6%	
N	10	
PMT	0	
FV	\$ (75,000)	
Type	0	

July 2, 2014

Oil Tanker Depot	600,000	
Cash		600,000

Oil Tanker Depot	41,879	
Asset Retirement Obligation		41,879

(b) December 31, 2014

Depreciation Expense	32,094	
Accumulated Depreciation –		
Oil Tanker Depot		32,094
(\$600,000 + \$41,879) ÷ 10 X 6/12		

Accretion Expense	1,256	
Asset Retirement Obligation		1,256
(\$41,879 X 6% X 6/12)		

(c) June 30, 2024

Asset Retirement Obligation	75,000	
Loss on Settlement of Asset Retirement		
Obligation	5,000	
Cash		80,000

EXERCISE 13-15 (Continued)**(d)**

Year	Beg. Carrying Amount	Accretion Expense (6%)	Ending Carrying Amount
June 30, 2015	41,879.00	2,512.74	44,391.74
2016	44,391.74	2,663.50	47,055.24
2017	47,055.24	2,823.31	49,878.55
2018	49,878.55	2,992.71	52,871.26
2019	52,871.26	3,172.28	56,043.55
2020	56,043.54	3,362.61	59,406.15
2021	59,406.15	3,564.37	62,970.52
2022	62,970.52	3,778.23	66,748.75
2023	66,748.75	4,004.93	70,753.68
2024	70,753.68	4,245.22	74,998.90

(e) Balance Sheet:**Property, Plant, and Equipment:**

Oil Tanker Depot	\$641,879	
Less: Accumulated Depreciation	<u>32,094</u>	609,785

Long-term Liabilities:

Asset Retirement Obligation	43,135
(\$41,879 + \$1,256)	

Income Statement:**Operating Expenses**

Depreciation Expense	32,094
Accretion Expense	1,256

(f) The accretion expense is a non-cash expense. It would be omitted from cash from operations in the statement of cash flows prepared using the direct method. It would be added back to net income in the statement of cash flows prepared using the indirect method.

EXERCISE 13-15 (Continued)

(g) If the company reports under IFRS, the main differences in accounting for the asset retirement costs and obligation are as follows:

- 1. If there are any constructive obligations related to retiring the oil tanker depot, the related costs would be included in the asset retirement obligation (ARO), in addition to the legal obligations recognized in part (a). Whereas under ASPE, only the costs associated with legal obligations are included in the ARO.**
- 2. The costs included in the capital asset would only be those retirement obligations related to the acquisition of the asset, not those retirement obligations related to the subsequent production of goods or services. Under IFRS, retirement costs related to the subsequent production of goods or services are included as inventory or product costs as the depot is used and the retirement costs increase due to production. Whereas under ASPE, the costs included in the capital asset are the retirement obligations resulting from both the acquisition of the asset and its subsequent use in producing inventory.**
- 3. The interest adjustment to the liability account recorded in part (b) would be recognized as a borrowing cost in the interest expense account. Whereas under ASPE, the interest adjustment is recognized as an operating expense in the accretion expense account.**

As an example, assuming that Crude Oil follows IFRS and that the ARO of \$75,000 at the end of the depot's useful life relates 50% to acquisition of the depot and 50% to the subsequent production:

EXERCISE 13-15 (Continued)

- The July 2, 2014 entry to acquire the oil tanker depot would be the same as under ASPE.
- Instead of capitalizing the full \$41,879 in the Oil Tanker Depot account, only $\frac{1}{2} \times \$41,879$ or \$20,940 would be capitalized at July 2, 2014.
- The depreciation expense for the six months ended December 31, 2014 would be $(\$600,000 + \$20,940) \div 10 \times 6/12 = \$31,047$
- Interest expense (which would be accretion expense under ASPE as discussed above) for the 6 months ended December 31, 2014 would be lower than under ASPE. It would be $\$20,940 \times 6\% \times 6/12 = \628 .
- An entry would have to be made to recognize the increased ARO due to the production activities for the 6 months ended December 31, 2014, with the costs charged to Inventory. This would be measured at the present value of the incremental costs caused by this production. If \$37,500 of the remediation obligation (ARO) was caused by the acquisition of the asset, then the other \$37,500 of the ARO, or \$1,875 every six months, would be caused by production. At the end of December 2014, \$1,078 is the present value of the incremental cost caused by production (PV \$1,875 using $i=6\%$ and $n=9.5$ periods which gives a PV factor of .57490). On June 30, 2015, an additional \$1,110 would be recognized as production costs and an increase in the ARO (PV \$1,875 using $i=6\%$ and $n=9$ periods which gives a PV factor of .59190). At June 30, 2015, additional interest expense would be recognized as well because \$1,078 has been included in the ARO since December 31, 2014. However, only \$1,078 is charged to Inventory and credited to the Asset Retirement Obligation at December 31, 2014.
- At June 30, 2024, the ARO will have accumulated to \$75,000, the same as under ASPE. Therefore the same entry would be made to recognize the \$80,000 expenditure for remediation and the \$5,000 loss.

EXERCISE 13-15 (Continued)

Note to instructors: This may be more detail than you would like to get into with your students, but is provided here as one way to calculate reasonable numbers for the entries. The following table sets out a “proof” that the ARO related to production activity and interest for the first year’s production will accumulate to 1/10 of the estimated retirement costs at the end of 10 years or \$3,750.

For each period, the ARO relating to the current production is recorded at its present value at the end of the period of production, added to the same liability account for the ARO recognized for the asset acquisition, and then accreted until the obligation is eventually retired.

There is no amount in the ARO account related to inventory production until December 31, 2014, so no accretion is needed in that first period.

	Present value of additional costs resulting from production in first year	Accretion at 6% per year	Balance of ARO related to production activity for first year
Jul.1/14	0	0	0
Dec.31/14	1,078	0	1,078
Jul.1/15	1,110	32	2,220
Jul.1/16	0	133	2,353
Jul.1/17	0	141	2,494
Jul.1/18	0	150	2,644
Jul.1/19	0	159	2,803
Jul.1/20	0	168	2,971
Jul.1/21	0	178	3,149
Jul.1/22	0	189	3,338
Jul.1/23	0	200	3,538
Jul.1/24	0	212	3,750

EXERCISE 13-16 (10-15 minutes)

- (a) **Cash (150 X \$4,000)..... 600,000**
Sales Revenue..... 600,000
- Warranty Expense..... 17,000**
Cash, Inventory, etc. 17,000
- Warranty Expense (\$45,000* – \$17,000).... 28,000**
Warranty Liability 28,000
***(150 X \$300)**
- (b) **Cash 600,000**
Sales Revenue..... 600,000
- Warranty Expense..... 17,000**
Cash, Inventory, etc. 17,000
- (c) **The cash basis of accounting for warranty costs is acceptable when the costs are not material or when the warranty period is relatively short. It may also be acceptable when the amount of the liability cannot be reasonably estimated or if future costs are not likely to be incurred.**

EXERCISE 13-17 (15-20 minutes)**(a) Estimated warranty expense for 2014:**

On 2014 sales: \$1,036,000 X .09* = \$ 93,240

* (2% of sales first year + 3% of sales second year + 4% of sales third year = 9% of sales)

Estimated warranty costs:

On 2012 sales \$ 810,000 X .09	\$ 72,900
On 2013 sales \$1,070,000 X .09	96,300
On 2014 sales \$1,036,000 X .09	<u>93,240</u>
Total estimated costs	262,440
Total warranty expenditures	<u>85,700*</u>
Balance of liability, 12/31/14	<u>\$176,740</u>

*2012—\$6,500; 2013—\$17,200, and 2014—\$62,000.

The liability account has a balance of \$176,740 at 12/31/14 based on the difference between the estimated warranty costs (totalling \$262,440) for the three years' sales and the actual warranty expenditures (totalling \$85,700) during that same period.

(b) The difference between actual warranty expenditures and the estimated amount would be treated as a change in accounting estimate and applied to the current and future years. The difference would be used as part of Cool Sound's experience in setting the rate for current and future years' transactions. If the difference is considered material, the additional warranty expenditures would be written off to the income statement in the current year.

EXERCISE 13-18 (20-25 minutes)

(a)	Accounts Receivable	3,000,000	
	Sales Revenue.....		3,000,000
	(500 X \$6,000)		
	Warranty Expense.....	30,000	
	Cash, Inventory, etc.		30,000
	Warranty Expense.....	90,000	
	Warranty Liability.....		90,000
	(\$120,000 – \$30,000)		
(b)	Accounts Receivable	3,000,000	
	Sales Revenue.....		2,840,000
	Unearned Warranty Revenue		160,000
	Warranty Expense.....	30,000	
	Cash, Inventory, etc.		30,000
	Unearned Warranty Revenue	40,000	
	Warranty Revenue		40,000
	[\$160,000 X (\$30,000/\$120,000)]		

EXERCISE 13-18 (Continued)**(c)**

Sales Revenue	\$3,000,000	\$2,840,000
Warranty Revenue	0	40,000
Warranty Expense	<u>(120,000)</u>	<u>(30,000)</u>
Net Income	<u>\$2,880,000</u>	<u>\$2,850,000</u>

Treating the warranty as an integral part of the sale under the “expense-warranty” approach will trigger a larger expense. This is because the full cost of servicing the product over the course of the warranty period must be estimated and disclosed in the period of sale. The warranty expense under a “sales-warranty” approach records only expenses incurred in the current period.

The presentation of sales revenue will also differ under the two approaches. Under the “expense-warranty” approach, the sales proceeds from selling the product generate only one revenue source. Under the “sales-warranty” approach, the sale of the product generates two different revenue streams (the sale of the product and the sale of the warranty contract as a service revenue) as well as two gross profit sources (sales revenue less cost of goods sold and warranty revenue net of warranty expense).

Since the same selling price is used under both approaches, we can see that the “sales-warranty” approach generates a lower income in the current year because a portion of the profit is deferred to future periods until it is earned as the service is provided.

- (d) If the warranty costs are considered to be immaterial, the cash basis method could be used and warranty costs expensed recognized in the year they are incurred. However, if the warranty costs are considered material to the company’s financial statements, the company may have to defer recognizing the revenue from the sale of the product until all costs can be measured and matched against the related revenues.**

EXERCISE 13-19 (15-20 minutes)**(a) Expense Approach:**

Cash / Accounts Receivable	3,000,000	
Sales Revenue.....		3,000,000
(1,000 X \$3,000)		
Warranty Expense.....	105,000	
Cash, Inventory, etc.		105,000
Warranty Expense.....	95,000	
Warranty Liability		95,000
[(1,000 X \$200) – \$105,000]		

December 31, 2014 financial statement amounts reported:

Balance Sheet	
Warranty liability	\$95,000
Income Statement	
Sales revenue	\$3,000,000
Warranty expense	200,000

EXERCISE 13-19 (Continued)**Revenue Approach:**

Cash / Accounts Receivable	3,000,000	
Sales Revenue.....		2,650,000
Unearned Warranty Revenue		350,000
Warranty Expense	105,000	
Cash, Inventory, etc.		105,000
Unearned Warranty Revenue	183,750	
Warranty Revenue		183,750
[\$350,000 X (\$105,000/\$200,000)]		

December 31, 2014 financial statement amounts reported:**Balance Sheet**

Unearned warranty revenue	\$166,250
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Income Statement

Sales revenue	\$2,650,000
Warranty revenue	183,750
Warranty expense	105,000

EXERCISE 13-19 (Continued)

- (b) When the expense approach is used to account for warranty costs, sales revenue will be higher because it is all considered to be earned upon the sale of the product. As well, the expense on the income statement will represent the total estimated costs of servicing the warranties (i.e., the actual costs of servicing the warranty in the period, plus a year end adjustment for expected future costs.) Therefore the total gross profit on the warranty work is recognized in the period the equipment is sold.

When the revenue approach is used, sales revenue will be lower because the total selling price is allocated between the sale of the product and the sale of the warranty service. There will be an unearned warranty revenue liability account for the portion of the warranty that has not been taken into revenue at year end. Warranty expense will be equal to the actual costs of servicing the warranty during the year. In summary, the profit on the warranty work is recognized later under the revenue approach—in the period in which the warranty work is performed.

In this situation, it makes more sense to choose the revenue approach. In this way, income is reported as it is earned, and is a better measure of performance. In addition, as the company is considering going public in a few years, and the bifurcation of revenues to multiple deliverables is required by IFRS, the revenue approach would be consistent with what will be required after we go public. It would make sense to adopt this accounting policy now so that a retrospective change is not required later.

EXERCISE 13-20 (15-20 minutes)**(a)**

Inventory of Premiums (8,800 X \$0.90)	7,920	
Cash		7,920
Cash (120,000 X \$3.30)	396,000	
Sales Revenue		396,000
Premium Expense	3,960	
Inventory of Premiums		3,960
[(44,000 ÷ 10) X \$0.90]		
Premium Expense	2,520	
Premium Liability		2,520
[(120,000 X 60%) – 44,000] ÷ 10 X \$0.90		

(b) Balance Sheet:**Current Assets:**

Inventory of Premiums (\$7,920 – \$3,960)	\$3,960
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Current Liabilities:

Premium Liability	2,520
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Income Statement:

Sales Revenue	\$396,000
Less: Premium Expense (\$3,960 + \$2,520)	(6,480)

EXERCISE 13-21 (20-30 minutes)

1	Liability for stamp redemptions, 12/31/13	\$13,000,000
	Cost of redemptions redeemed in 2014	<u>(6,000,000)</u>
		7,000,000
	Cost of redemptions to be redeemed in 2015	
	(\$5,200,000 x 80%)	<u>4,160,000</u>
	Liability for stamp redemptions, 12/31/14	<u><u>\$11,160,000</u></u>
2 (a)	Total coupons issued	\$800,000
	Redemption rate	<u>60%</u>
	To be redeemed	480,000
	Handling charges (\$480,000 X 10%)	<u>48,000</u>
	Total cost	<u><u>\$528,000</u></u>
	Total cost	\$528,000
	Total payments to retailers	<u>330,000</u>
	Liability for unredeemed coupons	<u><u>\$198,000</u></u>
(b)	Premium expense	<u><u>\$528,000</u></u>

EXERCISE 13-21 (Continued)

3 (a) Boxes sold	700,000
Sale price per unit related to premium	X \$1.00
Unearned revenue recorded in 2014	<u>\$700,000</u>

Total coupons expected to be redeemed (700,000 x 60%)	420,000
Less: coupons redeemed during 2014	<u>105,000</u>
Coupons still to be redeemed, 12/31/14	315,000
Total coupons expected to be redeemed	÷ <u>420,000</u>
% of unearned revenue to be earned after 2014	<u>75%</u>

Unearned revenue recorded in 2014	\$700,000
% of unearned revenue to be earned after 2014	<u>X 75%</u>
Unearned revenue (adjusted), 12/31/14	<u>\$525,000</u>

(b) Total coupons redeemed in 2014	105,000
Cost per redemption (\$6.25 – \$4.75)	<u>\$1.50</u>
Premium expense	<u>\$157,500</u>

(c)		
Cash	3,150,000	
Sales Revenue (700,000 X \$3.50).....		2,450,000
Unearned Revenue (700,000 x \$1.00)...		700,000

Cash (105,000 X \$4.75).....	498,750	
Premium Expense (105,000 X [\$5.00 + \$1.25 - \$4.75])	157,500	
Inventory of Premiums (105,000 X \$5.00).....		525,000
Cash/Accounts Payable (105,000 X \$1.25)		131,250

Unearned Revenue (700,000 X 25%)	175,000	
Sales Revenue.....		<u>175,000</u>

EXERCISE 13-21 (Continued)

- (d) An unredeemed coupon represents an obligation that arose from a past sale transaction, which may result in a transfer of assets (cash and inventory) upon coupon redemption. The company has little or no discretion to avoid the obligation. Therefore the unredeemed coupons meet the definition of a liability. Their fair value should be represented as unearned revenue on the balance sheet because a coupon was offered with each box of pie mix purchased, and a portion of the sales revenue related to each box of pie mix sold was related to the promotional coupon that was included with each box. The unredeemed coupons represent unearned revenue to be settled by delivery of goods in the future, upon coupon redemption.**

EXERCISE 13-22 (10-15 minutes)**(a) Balance Sheet:****Current Liabilities:**

Premium Liability*	\$600
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Income Statement:

Premium Expense	\$1,500
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* Total estimated redemptions of stickers, at cost

(25,000 X 10% ÷ 10 X \$10) X 60%	\$1,500
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Stickers redeemed in current year

(25,000 x 6% ÷ 10 x \$10) X 60%	<u>900</u>
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Estimated future redemptions, at cost	<u>\$ 600</u>
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(b)

Premium Expense	900	
Inventory		900

(cost of free product given in exchange
when stickers are redeemed)

Premium Expense	600	
Premium Liability		600

(liability for unredeemed stickers)

EXERCISE 13-23 (15-20 minutes)**(a)****(i) Coupon****Estimated promotion expense to be reported on income statement:**

Remaining estimated redemptions of coupons	
(50 coupons to be used in future	
X 10% discount X \$75 average sale)	\$375
Coupons already used	<u>250</u>
Total promotion expense	<u>\$625</u>

Balance sheet disclosure:

Unredeemed coupons liability	\$375
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(ii) Sick time**As it is possible that these amounts will be paid in the future, and there is little likelihood that the employees will resign, the full amount should be accrued.****Balance Sheet:**

Sick pay wages payable:	
(2 employees X \$100/day X 4 days X 50%)	\$400

Income Statement:**Increase to salaries and wages expense on the income statement:**

- For the sick days bonus outstanding related to the liability:	
(2 employees X \$100/day X 4 days X 50%)	\$400

EXERCISE 13-23 (Continued)

- (b) The customer loyalty program offers future discounts of \$10 for accumulating sales of \$250. Under ASPE, these types of programs may be evaluated as a revenue arrangement with multiple deliverables. The fair value of the award credits would be recognized as unearned revenue, a liability, with each sale. When customers redeem their award credits, the amount would be recognized as revenue.

However, not all of the awards will be redeemed, as customers may lose their card, move away, or forget to redeem their award once it is earned. Once the company has some experience in order to estimate how many award credits will be redeemed, compared to the total credits awarded to customers, some adjustment can be made to the liability account at year end.

If the program is accounted for as a revenue arrangement with multiple deliverables, a liability must be recorded as each customer earns sales “credits” towards the \$250 total. The fair value of each credit given for each dollar of sales is \$0.04 ($\$10/\250). Therefore, each sale to a customer who is a member of the customer loyalty program must be split, with 4% of the sale being recorded as unearned revenue, and the balance as a sale in the period of the transaction. When customers accumulate \$250 in credits, and come in to receive their \$10 discounts, this amount will be adjusted from unearned revenue to sales.

EXERCISE 13-24 (20-30 minutes)

- 1.** The *CICA Handbook for Private Enterprises* section 3290 requires that, when some amount within the range appears at the time to be a better estimate than any other amount within the range, that amount be accrued. When no amount within the range is a better estimate than any other amount, the dollar amount at the low end of the range is accrued and the dollar amount of the high end of the range is disclosed. Since the information indicates that it is likely that a liability has been incurred at December 31, 2014, and a range of possible amounts can be reasonably determined, the criteria for recording a liability are met. In this case, therefore, Sugarpost Inc. would report a liability of \$900,000 at December 31, 2014.
- 2.** Su Li Corp. would not be required to make any entry. The wage increase is for the coming two years and does not relate to the current or prior years.
- 3.(a)** The loss should be accrued since both criteria (it is likely that a loss is incurred and the amount of the loss can be reasonably determined) for recording the contingency are met. Given that the loss is covered by insurance, except for the \$500,000 deductible, only the \$500,000 should be accrued.

(b) Under IFRS requirements, the recognition criterion used to determine the chance of occurrence of a confirming future event is “probable,” which is interpreted to mean “more likely than not.” This is a somewhat lower hurdle than the “likely” required under ASPE. If the amount cannot be measured reliably, no liability is recognized under IFRS either; however, the standard indicates that it is only in very rare circumstances that this would be the case. If recognized, IAS 37 requires the best estimate and an “expected value” method to be used to measure the liability. As in part (a) above, this would be the \$500,000 deductible.

EXERCISE 13-24 (Continued)

- 4. This is a gain contingency because the amount to be received will be in excess of the carrying amount of the plant. Under ASPE, gain contingencies are not recorded and are disclosed in the notes only when the probabilities are high that a gain contingency will become reality.**

EXERCISE 13-25 (15-20 minutes)

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

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

$$(b) \quad \begin{aligned} \text{Acid-test ratio} &= \frac{\text{Cash} + \text{Marketable Securities} + \text{Receivables}}{\text{Current Liabilities}} \\ &= \frac{\$115,000}{\$70,000} = 1.64 \end{aligned}$$

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

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

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

$$(d) \quad \begin{aligned} \text{Rate of return on assets} &= \frac{\text{Net Income}}{\text{Average Total Assets}} \\ &= \frac{\$27,000}{\$430,000} = 6.28\% \end{aligned}$$

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.

EXERCISE 13-25 (Continued)

$$\begin{aligned}
 \text{(e) Days payables outstanding} &= \frac{\text{Average Trade Accounts Payable}}{\text{Average Daily Cost of Total Operating Expenses}} \\
 &= \frac{\$70,000}{\$471,000^*/365} = 54.2 \text{ days}
 \end{aligned}$$

* (\$420,000 + \$51,000)

This ratio measures the time it takes a company to pay its trade accounts payable and provides one indication related to the liquidity of the enterprise if the number of days exceeds the normal credit period for the industry, or if the ratio reveals an increasing trend.

EXERCISE 13-26 (20-25 minutes)**(a)**

$$1. \text{ Current ratio} = \frac{\$773,000}{\$240,000} = 3.22 \text{ times}$$

$$2. \text{ Acid-test ratio} = \frac{\$52,000 + \$198,000 + \$80,000}{\$240,000} = 1.38 \text{ times}$$

$$3. \text{ Accounts receivable turnover} = \frac{\$1,640,000}{\frac{\$80,000 + \$198,000}{2}} = 11.8 \text{ times}$$

(or approximately every 31 days)

$$4. \text{ Inventory turnover} = \frac{\$800,000}{\frac{\$360,000 + \$440,000}{2}} = 2 \text{ times}$$

(or approximately every 183 days)

$$5. \text{ Days payables outstanding} = \frac{\frac{\$145,000 + \$220,000}{2}}{\frac{\$800,000}{365}} = 83 \text{ days}$$

$$6. \text{ Rate of return on assets} = \frac{\$360,000}{\frac{\$1,400,000 + \$1,630,000}{2}} = 23.76\%$$

$$7. \text{ Profit margin on sales} = \frac{\$360,000}{\$1,640,000} = 21.95\%$$

EXERCISE 13-26 (Continued)

- (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 and the high days payables outstanding. The two ratios may be linked where extended credit terms are provided by suppliers if the inventory is slow-moving. The rate of return on assets and profit margin on sales are extremely good and indicate that the company is employing its assets advantageously.**
- (c) **Unearned revenue is a liability that arises from current sales but for which some services or products are owed to customers in the future. At the time of sale, customers pay not only for the delivered product, but they also pay for future products or services. 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. 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, the 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.**

EXERCISE 13-27 (15-25 minutes)

(a) 1. $\$318,000 \div \$87,000 = 3.66$ times

2. $\$820,000 \div \frac{\$200,000 + \$170,000}{2} = 4.43$ times = 82 days

3. $\$1,400,000 \div \$95,000 = 14.74$ times

4. $365 \div 14.74$ times = 25 days

5. $\$32,000 \div \$820,000 \times 365 = 14$ days

6. $\$410,000 \div 52,000 = \7.88

7. $\$410,000 \div \$1,400,000 = 29.3\%$

8. $\$410,000 \div \$488,000 = 84.02\%$

(b) 1. No effect on current ratio.

2. Weaken current ratio by increasing current assets and current liabilities by a like amount.

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.

TIME AND PURPOSE OF PROBLEMS

Problem 13-1 (Time 40-50 minutes)

Purpose—to present the student with an opportunity to prepare journal entries for a variety of situations related to liabilities. The situations presented include purchases and payments on account, and borrowing funds by giving a zero-interest-bearing note, sales tax, deposits and income tax. The student is also required to prepare year-end adjusting entries and to calculate sales tax two ways.

Problem 13-2 (Time 30-35 minutes)

Purpose—to present the student with an instalment note with a current and long-term portion. The student must prepare the amortization schedule for the note and the related journal entries. The balance sheet presentation is also required to emphasize the current amounts related to the note for two consecutive year ends.

Problem 13-3 (Time 45-55 minutes)

Purpose—to provide the student with experience in calculating the amounts of various liabilities and determining the portion relating to current liabilities. The student must calculate the interest payable on bonds payable and notes payable, warranty liability, employee withholding amounts payable, GST payable, and other miscellaneous payables. The student is also required to discuss why certain items were excluded from current liabilities and which items are considered financial liabilities. Journal entries are not required. The student must also discuss debt covenants and income statement presentation of revenue from gift cards. This problem is an excellent overview of chapter content.

Problem 13-4 (Time 25-35 minutes)

Purpose—to present the student a comprehensive problem in determining various liabilities and present findings in writing. Issues addressed relate to asset retirement obligation, warranties, HST and litigation.

Problem 13-5 (Time 20-30 minutes)

Purpose—to present the student with an opportunity to prepare journal entries for four weekly payrolls. The student must calculate income tax to be withheld, CPP premiums, and employment insurance. The student must record two pay periods where employees are on vacation.

TIME AND PURPOSE OF PROBLEMS (CONTINUED)

Problem 13-6 (Time 20-25 minutes)

Purpose—to provide the student with the opportunity to prepare journal entries for a monthly payroll. The student must calculate income tax to be withheld, CPP contributions and Employment Insurance. The student must also calculate the total expense for the company for the month.

Problem 13-7 (Time 25-30 minutes)

Purpose—to provide the student with experience in calculating bonuses under a variety of compensation plans. The student must calculate a bonus before deduction of bonus and income tax, after deduction of bonus but before deduction of income tax, and before deduction of bonus but after deduction of income tax.

Problem 13-8 (Time 45-50 minutes)

Purpose—to provide the student with a comprehensive problem dealing with contingent losses. The student is required to prepare journal entries for each of four independent situations. For each situation the student must also discuss the appropriate disclosure in the financial statements. The situations presented include a lawsuit, an environmental assessment, an expropriation, and self-insurance situation. This problem challenges the student not only to apply the guidelines set forth in *CICA Handbook*, Part II, Section 3290, but also to develop reasoning as to how the guidelines relate to each situation. The student is also required to discuss ethical issues inherent in contingent liabilities. A good problem to analyze the effects of Section 3290 on a variety of situations.

Problem 13-9 (Time 25-30 minutes)

Purpose—to provide a problem in determining various liabilities, including advance payments, self insurance, litigation, commitments, guarantees, and loss contingencies. The students must also discuss any required disclosures.

Problem 13-10 (Time 20-25 minutes)

Purpose—to provide the student with an opportunity to prepare journal entries and balance sheet presentations for warranty costs under the cash basis and the expense approach. 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 balance sheet.

TIME AND PURPOSE OF PROBLEMS (CONTINUED)

Problem 13-11 (Time 20-30 minutes)

Purpose—to provide the student with a problem covering the revenue approach. The student is required to prepare journal entries in the year of sale and in subsequent years as warranty costs are incurred. Also required are balance sheet presentations for the year of sale and two subsequent years.

Problem 13-12 (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 warranty liability, and an estimated liability for premium claims outstanding. Journal entries are not required. This problem should challenge the better students.

Problem 13-13 (Time 30-45 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. The student is required to prepare the entries under two different approaches, the premium redemptions are recorded as premium expense or as a decrease of the premium liability. Statement presentation is also required.

Problem 13-14 (Time 30-45 minutes)

Purpose—to present the student with a 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 and determine if the liability is financial. This very realistic problem challenges the student's ability to account for all transactions related to premium offers.

TIME AND PURPOSE OF PROBLEMS (CONTINUED)

Problem 13-15 (Time 25-35 minutes)

Purpose—the student must calculate warranty expense, warranty liability, premium expense, inventory of premiums, and estimated liability for premiums. The student is also required to discuss how the accounting would be affected if the warranty were treated under the revenue approach.

Problem 13-16 (Time 35-45 minutes)

Purpose—to provide the student with experience in guarantees of indebtedness and contingencies. The student is required to provide journal entries related to guarantees and loss contingencies and to identify related disclosures. The situation is complicated by receivables from the guaranteed customer and revenue recognition issues related to the guarantee fee. A challenging problem.

Problem 13-17 (Time 45-50 minutes)

Purpose—to present the student with the problem of determining the proper amount of and disclosure for two contingent losses due to lawsuits. The student is required to prepare journal entries and notes. 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 losses.

SOLUTIONS TO PROBLEMS**PROBLEM 13-1**

(a)		
February 2		
Purchases (\$46,000 X 98%)	45,080	
 Accounts Payable		45,080
February 26		
Accounts Payable	45,080	
Purchase Discounts Lost	920	
 Cash		46,000
April 1		
Trucks	50,000	
 Cash		5,000
 Notes Payable		45,000
May 1		
Cash	83,000	
 Notes Payable		83,000
June 30		
Income Tax Expense	19,000	
 Cash		19,000
August 14		
Retained Earnings (Dividends Declared)	13,000	
 Dividends Payable		13,000
September 10		
Dividends Payable	13,000	
 Cash		13,000
December 5		
Cash	750	
 Returnable Deposit		750

PROBLEM 13-1 (Continued)

December 10		
Display Cases (\$8,000 X 1.08)	8,640	
GST Receivable (\$8,000 X .05).....	400	
Accounts Payable		9,040

December 31		
Cash	89,270	
Sales Revenue.....		79,000
Sales Tax Payable (\$79,000 X .08).....		6,320
GST Payable (\$79,000 X .05).....		3,950

December 31		
Rent Expense	4,870	
Rent Payable		4,870
(\$2,500 + [3% X \$79,000])		

December 31		
Parking Lot	46,000	
Asset Retirement Obligation		46,000

December 31		
Income Tax Expense	19,000	
Cash		19,000

December 31		
Income Tax Expense	3,000	
Income Tax Payable.....		3,000
(\$205,000 X 20%) – (\$19,000 X 2)		

December 31		
Interest Expense (\$45,000 X 8% X $\frac{3}{4}$).....	2,700	
Interest Payable.....		2,700

December 31		
Interest Expense (\$9,000 X 8/12)	6,000	
Notes Payable.....		6,000

PROBLEM 13-1 (Continued)**(b) Current Liabilities:**

Accounts Payable		\$9,040
Notes Payable.....	\$45,000	
Interest Payable.....	<u>2,700</u>	47,700
Notes Payable.....		89,000
Sales Tax Payable		6,320
GST Payable (\$3,950 – \$400)		3,550
Rent Payable		4,870
Income Tax Payable.....		3,000
Returnable Deposit		750
Total Current Liabilities		<u>\$164,230</u>

(c) December 10

Display Cases (\$8,000 + [\$8,000 X 1.05 X .08]) ..	8,672	
GST Receivable (\$8,000 X .05).....	400	
Accounts Payable		9,072

December 31

Cash	89,586	
Sales Revenue		79,000
Sales Tax Payable		
(\$79,000 X 1.05 X .08).....		6,636
GST Payable (\$79,000 X .05).....		3,950

- (d) 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 notes discloses amounts, maturity dates, collateral, subordinations, and restrictions of existing contractual obligations, all of which are important to potential and existing creditors. The assets and earning power are likewise important to a banker considering a loan.**

PROBLEM 13-1 (Continued)

- (e) Current liabilities are obligations whose liquidation is reasonably expected to require the use of existing resources properly classified as current assets, or the creation of other current liabilities.**

PROBLEM 13-2

(a)

<u>Date</u>	<u>Payment</u>	<u>Interest (7%)</u>	<u>Principal repayment</u>	<u>Carrying Amount of Note</u>
1/1/14				\$85,000
1/1/15	\$32,389	\$5,950	\$26,439	58,561
1/1/16	\$32,389	\$4,099	\$28,290	30,271
1/1/17	\$32,389	\$2,119	\$30,271*	0

* rounding of \$1

(b)

1/1/14	Machinery	85,000	
	Notes Payable		85,000
12/31/14	Interest Expense	5,950	
	Interest Payable		5,950
1/1/15	Interest Payable.....	5,950	
	Notes Payable	26,439	
	Cash		32,389

(c)

Bian Inc.
Balance Sheet (partial)
December 31, 2014

Current Liabilities:

Interest Payable	\$5,950	
Current portion of long-term note payable	<u>26,439</u>	\$32,389

Long-term Liabilities

Note Payable	\$85,000	
Less: current portion	<u>(26,439)</u>	\$58,561

PROBLEM 13-2 (Continued)

(d)

Bian Inc.
Balance Sheet (partial)
December 31, 2015

Current Liabilities:

Interest Payable	\$4,099	
Current portion of long-term note payable	<u>28,290</u>	\$32,389

Long-term Liabilities

Note Payable	\$58,561	
Less: current portion	<u>(28,290)</u>	\$30,271

(e)

Bian Inc.
Balance Sheet (partial)
December 31, 2014

Current Liabilities:

Interest Payable*	\$2,975	
Current portion of long-term note payable	<u>26,439</u>	\$29,414

Long-term Liabilities

Note Payable	\$85,000	
Less: current portion	<u>(26,439)</u>	\$58,561

***\$5,950 X 6/12 = \$2,975**

PROBLEM 13-3**(a)****Current Liabilities:**

Accounts payable (\$414,000 – \$23,000)	\$ 391,000
Liability to affiliated company	23,000
Notes payable (\$150,000 + \$200,000)	350,000
GST payable (Schedule 6)	11,900
Dividends payable	50,000
Bonus payable (75% X \$25,000)	18,750
Unearned revenue – Gift cards (Schedule 1)	657,500
Accrued liabilities (Schedule 2)	<u>545,749</u>
Total current liabilities	<u>\$2,047,899</u>

Schedule 1:

Unearned Revenues – Gift cards, Mar. 1, 2013	\$ 950,000
New gift card purchases	225,000
Gift card redemptions	(375,000)
15% of Mar. 1, 2013 balance recognized as revenue (15% X \$950,000)	<u>(142,500)</u>
Unearned revenue – Gift cards, Feb. 28, 2014	<u>\$657,500</u>

Schedule 2:

Interest payable (Schedule 3)	\$ 122,709
Warranty liability (Schedule 4)	1,240
Salaries and wages payable	220,000
Employee withholdings payable (Schedule 5)	105,300
Union dues payable	21,500
Audit fee payable	<u>75,000</u>
Total accrued liabilities	<u>\$545,749</u>

PROBLEM 13-3 (Continued)**Schedule 3:**

Interest on the bond	
(\$4,000,000 X 7% X 3/12)	\$ 70,000
Interest on Note due 04/01/14	
(\$150,000 X 8% X 11/12)	11,000
Interest on Note due 01/31/15 (\$200,000 X 9% X 1/12)	1,500
Interest on Note due 03/15/15	
(\$500,000 X 7% X 11.5/12)	33,542
Interest on Note due 10/30/16 (\$250,000 X 8% X 4/12)	<u>6,667</u>
Total interest payable	<u>\$ 122,709</u>

Schedule 4:

Warranty liability 02/28/13	\$5,700
Less warranty claims on 2012-2013 sales	<u>(4,900)</u>
Remaining warranty liability	800
Warranty liability on 2013-2014 sales for following	
12 months (\$154,000 X 1%)	1,540
Less: warranty claims on 2013-2014 sales	<u>(1,100)</u>
Current warranty liability 02/28/14	<u>\$1,240</u>

Schedule 5:

El premiums payable (2.4 X \$9,500)	\$ 22,800
CPP contributions payable (2 X \$16,900)	33,800
Employee income tax deductions payable	<u>48,700</u>
Employee withholdings payable	<u>\$105,300</u>

Schedule 6:

Net GST payable, 01/31/14 (\$60,000 – \$34,000)	\$ 26,000
Less: payment to government on 15 th of Feb./14	(26,000)
GST charged on February sales	39,900
Net of GST Receivable	<u>(28,000)</u>
Net GST payable, 02/28/14	<u>\$11,900</u>

PROBLEM 13-3 (Continued)

- (b) All current liabilities listed with the exception of the unearned revenues – gift cards, the warranty liability, the employee withholdings payable (employee income tax deductions payable, EI premiums payable and CPP contributions payable), and GST payable are financial liabilities.

A financial liability is any liability that is a contractual obligation to deliver cash or other financial assets to another party, or to exchange financial assets or financial liabilities with another party under conditions that are potentially unfavourable to the entity. A contractual obligation refers to an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable at law. Contracts, and thus financial instruments, may take a variety of forms and need not be in writing.

Items such as unearned revenue and most warranty obligations are not financial liabilities because the probable outflow of economic benefits associated with them is the delivery of goods and services rather than cash or another financial asset.

GST payable and employee withholdings payable are not considered financial liabilities because they are not contractual in nature. They are created as a result of statutory requirements imposed by governments.

PROBLEM 13-3 (Continued)**(c) Items excluded from current liabilities:**

- 1. Bonds payable were excluded based on the assumption that the bonds will not be redeemed in the coming period or operating cycle, whichever is longer.**
- 2. Notes payable due 03/15/15 and 10/30/16 were excluded because their due date is beyond the coming period.**
- 3. Warranty liability for costs of 1.5% of 2013-2014 sales ($1.5\% \times \$154,000 = \$2,310$) would be shown as a long-term liability. The costs of honouring the warranty would occur beyond the coming period.**
- 4. Bonus payable in March 2015 ($\$25,000 \times 25\% = \$6,250$).**

(d) Under ASPE, if Hrudka is not in compliance with the bank's debt covenants, the note would be reclassified as a current liability. A breach of the covenants of long-term debt gives the creditor the right to demand short-term repayment of the debt (the liability becomes payable on demand). The note can be classified as long-term only if the creditor waives in writing the covenant (agreement) requirements, or the violation has been cured within the grace period and it is likely Hrudka will not violate the covenant requirements within a year from the balance sheet date.

(e) Revenue from redeemed cards should be shown with other product sales and offset against cost of sales to accurately measure gross profit. Revenue from unredeemed gift cards do not have a related product cost and will distort the gross margin if they are included in product sales revenues. They should be shown as a separate source of revenue. Given the increasing popularity of gift cards, the revenue should be shown as an ongoing source of revenue in the income from operations section of the income statement and not as "other revenues".

PROBLEM 13-4**(a)**

Cost of storage tanks	\$110,000
Asset retirement cost (\$28,000 X .55839)	
[PV of \$28,000 (n=10, i=6%)]	<u>15,635</u>
Balance in asset account, Feb. 28, 2014	<u>\$125,635</u>
 Depreciation for 2014 (\$125,635 ÷ 10 X 10/12):	 \$10,470
 Presentation on Dec. 31, 2014 balance sheet:	
Asset cost.....	\$125,635
Less: Accumulated depreciation	<u>(10,470)</u>
	<u>\$115,165</u>

(b)

Asset retirement obligation (ARO),	
Feb. 28, 2014 (from above)	\$15,635
2014 interest expense	
(\$15,635 X 6% X 10/12)	<u>782</u>
Balance of ARO, December 31, 2014	16,417
2015 interest expense	
(\$16,417 X 6%)	<u>985</u>
Balance of ARO, December 31, 2015	17,402
2016 interest expense	
(\$17,402 X 6%)	<u>1,044</u>
Balance of ARO, December 31, 2016	<u>\$18,446</u>

(c)

Unearned warranty revenue recorded in 2014	
(\$970 X 20)	\$19,400
Portion unearned at December 31, 2014	<u>X 75%</u>
Unearned warranty revenue, December 31, 2014	<u>\$14,550</u>

PROBLEM 13-4 (Continued)

(d) Warranty expense on the 2014 income statement will be \$2,700.

(e)

HST collected on sales (and therefore payable to the government)	
(20 machines X \$12,000 X 15%).....	\$36,000
HST paid on purchase of underground tanks (and therefore receivable from government)	
(\$110,000 X 15%)	<u>16,500</u>
	<u>\$19,500</u>

Healy will send a cheque to the federal government for \$19,500 to pay its net HST liability.

(e) Healy's warranty obligation represents a stand-ready obligation to provide parts and labour under the warranty agreement at any time throughout the two-year contract period. This argument may support straight-line recognition of warranty revenue over the two-year contract term. On the other hand, if historical evidence indicates that warranty services are usually provided later in the two-year warranty period, a higher proportion of warranty revenue is actually earned in the later years of the contract period, and a higher proportion of warranty revenue should be recognized later in the contract. This would result in lower warranty revenue and net income in year 1, and a higher unearned warranty revenue liability in year 1.

PROBLEM 13-4 (Continued)
(e) Continued

In this case, the company's 25% estimate of warranty revenue being earned in 2014 looks realistic. The \$2,700 of costs incurred in 2014 is exactly 25% of the estimate of total costs over the three years. In addition, if the assumption is that the warranties have been outstanding, on average, for half a year in 2014, they will be outstanding also for a full year in 2015 and the remaining half year in 2016. This supports an assumption of being earned evenly over the two year warranty period.

A financial statement user should be aware that accounting for warranties affects liabilities on the statement of financial position, as well as revenue and net income on the income statement, for multiple periods. If unsupported or biased assumptions are used in accounting for warranties, the resulting financial statements may not reflect the appropriate financial position or performance of the company.

PROBLEM 13-5

(a) Entries for Payroll 1 and 4 (individually)

Salaries and Wages Expense	2,540.00*	
Employee Income Tax Deductions		
Payable (10% X \$2,540)		254.00
El Premiums Payable **		46.48
CPP Contributions Payable ***		125.73
Union Dues Payable (1% X \$2,540)		25.40
Cash		2,088.39

$$*\$450 + \$110 + \$250 + \$1,250 + \$480 = \$2,540$$

Payroll Tax Expense	190.80	
El Premiums Payable (1.4 X \$46.48)		65.07
CPP Contributions Payable		125.73

$$** \text{ El Premiums} = \$2,540 \times 1.83\% = \$46.48$$

$$*** \text{ CPP Contributions} = \$2,540 \times 4.95\% = \$125.73$$

Entries for Payroll 2 and 3 (individually)

Vacation Wages Payable		
(\$450 + \$110 + \$1,250)	1,810.00	
Salaries and Wages Expense (\$250 + \$480)	730.00	
Employee Income Tax Deductions		
Payable (10% X \$2,540)		254.00
El Premiums Payable		46.48
CPP Contributions Payable		125.73
Union Dues Payable (1% X \$2,540)		25.40
Cash		2,088.39

Payroll Tax Expense	190.80	
El Premiums Payable (1.4 X \$46.48)		65.07
CPP Contributions Payable		125.73

PROBLEM 13-5 (Continued)**(b) Monthly Payment of Payroll Liabilities****Employee Income Tax Deductions Payable**

(\$254.00 X 4)	1,016.00
-----------------------------	-----------------

EI Premiums Payable

[((\$46.48 X 4) + (\$65.07 X 4)).....	446.20
--	---------------

CPP Contributions Payable (\$125.73 X 8).....	1,005.84
--	-----------------

Union Dues Payable (\$25.40 X 4)	101.60
---	---------------

Cash	2,569.64
-------------------	-----------------

(c) Vacation Entitlement for August

Salaries and Wages Expense	261.60
---	---------------

Vacation Wages Payable	261.60
-------------------------------------	---------------

\$2,540 X 2 weeks X 4% =	\$203.20
---------------------------------	-----------------

\$730 X 2 weeks X 4% =	58.40
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<u>\$261.60</u>

PROBLEM 13-6

(a)

Name	Earnings to Aug. 31	Sept. Earnings	Income Tax With- holding	CPP	EI	Union Dues
L. Meloche	\$ 6,800	\$ 800	\$ 80	\$ 39.60	\$14.64	\$8.00
P. Groot	6,300	700	70	34.65	12.81	7.00
D. Beauchamp	7,600	1,100	110	54.45	20.13	11.00
C. Regier	13,600	1,900	190	94.05	34.77	19.00
Total	<u>\$34,300</u>	<u>\$4,500</u>	<u>\$450</u>	<u>\$222.75</u>	<u>\$82.35</u>	<u>\$45.00</u>

Salaries and Wages Expense	4,500.00	
Employee Income Tax		
Deductions Payable		450.00
EI Premiums Payable		82.35
CPP Contributions Payable		222.75
Union Dues Payable		45.00
Cash		3,699.90

(b) Payroll Tax Expense	338.04	
EI Premiums Payable (1.4 X \$82.35) ..		115.29
CPP Contributions Payable		222.75

(c) Employee Income Tax Deductions		
Payable	450.00	
EI Premiums Payable		
(\$82.35 + \$115.29)	197.64	
CPP Contributions Payable		
(\$222.75 + \$222.75)	445.50	
Union Dues Payable	45.00	
Cash		1,138.14

(d) Salaries and Wages Expense	\$4,500.00
Payroll tax expense	<u>338.04</u>
Total cost for September 2014	<u>\$4,838.04</u>

PROBLEM 13-7**(B = bonus; T = tax)**

(a)

$$\begin{aligned} B &= 0.12 (\$250,000) \\ B &= \$30,000 \\ T &= .30 (\$250,000 - \$30,000) \\ T &= \$66,000 \end{aligned}$$

(b)

$$\begin{aligned} B &= 0.12 (\$308,000 - B) \\ B &= \$36,960 - .12B \\ 1.12B &= \$36,960 \\ B &= \$33,000 \\ T &= 0.30 (\$308,000 - \$33,000) \\ T &= \$82,500 \end{aligned}$$

(c)

$$\begin{aligned} B &= 0.12 (\$350,000 - T) \\ T &= 0.30 (\$350,000 - B) \\ B &= 0.12 [\$350,000 - 0.30 (\$350,000 - B)] \\ B &= 0.12 (\$350,000 - \$105,000 + .3B) \\ B &= \$29,400 + .036B \\ 0.964B &= \$29,400 \\ B &= \$30,497.93 \\ T &= .30 (\$350,000 - \$30,497.93) \\ T &= \$95,850.62 \end{aligned}$$

PROBLEM 13-8**(a)**

- | | | | |
|-----------|---|------------------|------------------|
| 1. | Litigation expense | 225,000 | |
| | Litigation Liability | | 225,000 |
|
 | | | |
| 2. | Loss Due to Environmental Clean-up.. | 500,000 | |
| | Liability for Environmental | | |
| | Clean-up | | 500,000 |
|
 | | | |
| 3. | Loss from Expropriation..... | 2,245,000 | |
| | Inventory, Accumulated | | 2,245,000 |
| | Impairment Losses, etc. (for each | | |
| | individual asset that has a value | | |
| | assessed to be impaired) | | |
| | [\$5,725,000 – (40% X \$8,700,000)] | | |
|
 | | | |
| 4. | No entry required. | | |

(b)

- 1. A loss and a liability have been recorded in the first case because (i) information is available prior to the issuance of the financial statements that indicates it is likely that a liability had been incurred at the date of the financial statements and (ii) the amount is reasonably estimable. That is, the occurrence of the uninsured accidents during the year plus the outstanding injury suits and the legal counsel's estimate of probable loss required recognition of a loss contingency.**
- No journal entry is recorded in the case of the \$60,000 injury suit since it is considered unlikely that a liability has been incurred at the date of the financial statements. If the amount were considered material it would be desirable to disclose the existence of the lawsuit in the notes to the financial statements.**

PROBLEM 13-8 (Continued)

- 2. A loss and a liability have been recorded because information is available prior to the issuance of the financial statements that indicates it is likely that a liability had been incurred at the date of the financial statements. Under ASPE, where a range of possible amounts is determined and no one amount within the range is more likely than another, the bottom of the range is usually accrued with the amount of the remaining exposure disclosed in the notes.**
- 3. An entry to record a loss and to establish reduced asset values 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 prior settlements for properties already expropriated. Enough evidence exists to reasonably estimate the amount of the probable loss resulting from impairment of assets at the balance sheet date. The amount of the loss is measured by the excess of the carrying amount of the assets over the expected compensation. At the time the expropriation occurs, the related assets are written off and any differences between the amount received and the reduced asset values will be adjusted to the Loss from Expropriation. In this case, it is asset values that have been impaired, not an additional liability that has been incurred. If there is significant uncertainty about which specific assets are affected, general allowance accounts (contra asset accounts) could be credited for each general category of asset.**

PROBLEM 13-8 (Continued)

4. Even though Sahoto's chemical product division is uninsurable due to high risk and has sustained repeated losses in the past, as of the balance sheet 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 loss contingency. 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 loss contingency. 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 balance sheet date and the amount of the loss must be reasonably estimable in order for a loss contingency to be recorded. Disclosure is required when one or both of the criteria for a loss contingency 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 unfavourable outcome.
- (c) In contingencies related to legal proceedings, the accrual for contingencies and the related disclosure can be construed as an admission of guilt and could weaken the company's position. Company's management has to balance the need for full disclosure with the need for careful management of the legal proceedings and protecting shareholder's interests by avoiding costly lawsuit damages. The ethical issues also involve the interpretation of terms such as "likely" and "reasonably estimable" in determining when and how much is shown on financial statements.

PROBLEM 13-9**(a) ASPE**

- | | | | |
|----|---|----------------|----------------|
| 1. | Unearned Subscriptions Revenue | 400,000 | |
| | Sales Revenue | | 400,000 |
| | (To record subscriptions earned during 2014) | | |

Carrying amount balance of liability account at 12/31/14	\$2,300,000
Adjusted balance (\$600,000 + \$500,000 + \$800,000)	<u>1,900,000</u>
Credit to sales revenue account	<u>\$ 400,000</u>

2. 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 balance sheet date. 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.

- | | | | |
|----|---|--|----------------|
| 3. | Litigation Expense 300,000 | | |
| | Litigation Liability | | 300,000 |
| | (To record estimated minimum damages on breach-of-contract litigation) | | |

Note disclosure would also be required indicating the nature of the loss contingency and that there is an exposure to loss in excess of the amount recorded.

PROBLEM 13-9 (Continued)

- 4. No entry should be made for this loss contingency, because it is not likely that an asset has been impaired or a liability has been incurred and the loss cannot be reasonably estimated as of the balance sheet date. The company must however disclose the guarantee in the notes to its financial statements, even if the likelihood of loss is remote. The note disclosure should include the nature of the guarantee, the maximum potential amount of future payments, the nature and extent of any recourse provisions and the carrying amount of any liability.**
- 5. No entry should be made since it does not represent a liability at the balance sheet date. The company should have a note disclosure for this contractual obligation since it represents a major capital expenditure commitment.**
- 6. No entry should be made for this loss contingency, because it is not likely that an asset has been impaired or a liability has been incurred and the loss cannot be reasonably estimated as of the balance sheet date. The loss contingency should be disclosed in the notes to financial statements.**

PROBLEM 13-9 (Continued)

(b) IFRS

- 3. IAS 37 would be similar to the ASPE standard except that under IAS 37, provisions are required for situations where it is “probable” or “more likely than not” that a present obligation exists. This is a somewhat lower hurdle than the “likely” required under ASPE. If the amount cannot be measured reliably, no liability is recognized under IFRS either; however, the standard indicates that it is only in very rare circumstances that this would be the case. If recognized, IAS 37 requires that the best estimate and an “expected value” method be used to measure the liability. This approach assigns weights to the possible outcomes according to their associated probabilities when measuring the amount of the provision, if a range of possible amounts is available.**

PROBLEM 13-10

(a)	Cash (400 X \$2,500)	1,000,000	
	Sales Revenue		1,000,000
(b)	Cash (400 X \$2,500)	1,000,000	
	Sales Revenue		1,000,000
	Warranty Expense	136,000	
	Warranty Liability		136,000
	(400 X [\$155 + \$185])		
(c)	No liability would be disclosed under the cash basis method, with respect to future costs due to warranties on past sales.		
(d)	Current Liabilities:		
	Warranty Liability		<u>\$68,000</u>
	Long-term Liabilities:		
	Warranty Liability		<u>\$68,000</u>
(e)	Warranty Expense	61,300	
	Inventory		21,400
	Salaries and Wages Payable		39,900
(f)	Warranty Liability	61,300	
	Inventory		21,400
	Salaries and Wages Payable		39,900

PROBLEM 13-10 (Continued)

- (g) The accrual basis expense approach results in matching of warranty costs with the revenues that generate them. The cash basis would be acceptable only where the warranty costs are immaterial or when the warranty period is relatively short. This is not the case for Brooks Corporation. Increasingly today, the asset and liability view and faithful representation drive the accounting model, resulting in the bifurcation or separation of the proceeds received into two or more revenue amounts for the various deliverables promised. This is referred to as the revenue approach.
- (h) Higher than predicted warranty expenditures will cause the Estimated Warranty Liability account to have an understated balance that will not be sufficient for future warranty obligations. Management must review actual warranty claims experience against the estimated warranty liability balances in order to adjust the rate used to record warranty expense in the current and future years. The discrepancy is treated as a change in an accounting estimate and is applied to the current and future periods. In 2016, management of Brooks Corporation would have to record a larger warranty expense in order to accurately measure the Estimated Warranty Liability.

PROBLEM 13-11

(a)	Cash	279,300	
	Sales Revenue (300 X \$850)		255,000
	Unearned Warranty Revenue		24,300
	(270 X \$90)		
	Warranty Expense	7,500	
	Warranty Liability		7,500
	(300 X \$25)		
(b)	Current Liabilities:		
	Warranty Liability		<u>\$ 7,500</u>
	Long-term Liabilities:		
	Unearned Warranty Revenue		<u>\$24,300</u>
(c)	Warranty Liability	7,350	
	Inventory.....		4,410
	Salaries and Wages Payable		2,940
	Warranty Liability (\$7,500 - \$7,350) ..	150	
	Warranty expense.....		150
(d)	Current Liabilities:		
	Unearned Warranty Revenue* ...		<u>\$ 8,100</u>
	Long-term Liabilities:		
	Unearned Warranty Revenue		<u>\$16,200</u>

*** The extended warranty revenues are expected to be earned evenly over the warranty period ($\$24,300 / 3 = \$8,100$).**

PROBLEM 13-11 (Continued)

(e)	Unearned Warranty Revenue	8,100	
	Warranty Revenue		8,100
	Warranty Expense	5,000	
	Inventory		2,000
	Salaries and Wages Payable		3,000
(f)	Current Liabilities:		
	Unearned Warranty Revenue		<u>\$ 8,100</u>
	Long-term Liabilities:		
	Unearned Warranty Revenue		<u>\$ 8,100</u>

PROBLEM 13-12**(a)**

Calculation of the sales price of batteries expected to be returned:

July – September sales X 8% return rate	
(\$1,800,000 + \$1,650,000 + \$2,050,000) X 8%	\$440,000
October – December sales X 10% return rate	
(\$1,425,000 + \$1,000,000 + \$900,000) X 10%	<u>332,500</u>
See also total in part (b)	<u>\$772,500</u>

Estimated cost to replace batteries that have been returned as defective (measured as the sales price of batteries to be returned X cost of goods sold percentage):

The account balance in the “Battery Warranty Expense” account for the period July 1 to December 31, 2014 is calculated as follows:

Estimated cost of replacing batteries related to the July – December sales:	
Cost to replace batteries (\$772,500 X 60%)	\$463,500
Freight cost (\$772,500 X 10%).....	77,250
Less: Salvage value (\$772,500 X 14%)	<u>(108,150)</u>
See also total in part (b)	432,600
Less: adjustment for the warranty liability not needed from expense estimate for the first half of the year	
	<u>(5,000)</u>
Battery warranty expense, July 1 – Dec. 31, 2014..	<u>\$427,600</u>

PROBLEM 13-12 (Continued)**(b)**

The amount of the provision required in the Warranty Liability account (for the battery warranty) as at December 31, 2014 is calculated as follows:

Month	Sales amount for month	% of battery returns expected	Sales price of batteries expect to be returned	Cost to replace defective batteries (= 60% + 10% – 14% = 56% of sales returns)	% of defective batteries remaining to be returned as at December 31, 2014	Provision required (= cost to replace X % remaining to be returned)
July	\$1,800,000	8%	\$ 144,000	\$ 80,640	10%	\$ 8,064
August	1,650,000	8%	132,000	73,920	20%	14,784
September	2,050,000	8%	164,000	91,840	30%	27,552
October	1,425,000	10%	142,500	79,800	50%	39,900
November	1,000,000	10%	100,000	56,000	80%	44,800
December	900,000	10%	<u>90,000</u>	<u>50,400</u>	100%	<u>50,400</u>
			<u>\$772,500</u>	<u>\$432,600</u>		<u>\$ 185,500</u>

PROBLEM 13-13

(a)

Inventory of Premiums.....	60,000	
Cash		60,000
(To record purchase of 40,000		
puppets at \$1.50 each)		

Cash	1,800,000	
Sales Revenue.....		1,800,000
(To record sales of 480,000 boxes		
at \$3.75 each)		

Premium Expense	34,500	
Inventory of Premiums		34,500
[To record redemption of 115,000		
coupons. Calculation:		
(115,000 ÷ 5) X \$1.50 = \$34,500]		

Premium Expense	23,100	
Estimated Liability for Premiums.....		23,100
[To record estimated liability for		
premium claims outstanding at		
December 31, 2014.]		

Calculation: Total coupons issued in 2014	<u>480,000</u>
--	-----------------------

Total estimated redemptions (40%)	192,000
Coupons redeemed in 2014	<u>115,000</u>
Estimated future redemptions	<u>77,000</u>

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

PROBLEM 13-13 (Continued)**(b)**

Inventory of Premiums.....	60,000	
Cash		60,000
(To record purchase of 40,000		
puppets at \$1.50 each)		
 Cash	 1,800,000	
Sales Revenue.....		1,800,000
(To record sales of 480,000 boxes		
at \$3.75 each)		
 Premium Expense	 57,600	
Estimated Liability for Premiums.....		57,600
[To record premium expense for		
the full estimated cost of the		
premium plan]		

Calculation:

Total coupons issued in 2014	480,000
Redemption rate	X 40%
Total estimated redemptions (40%)	192,000
Number of coupons per premium	÷ 5
Number of premium claims	38,400
Cost of premium	X \$1.50
Total premium expense for the year 2014	<u>\$57,600</u>

Estimated Liability for Premiums.....	34,500	
Inventory of Premiums		34,500
[To record redemption of 115,000		
coupons. Calculation:		
(115,000 ÷ 5) X \$1.50 = \$34,500]		

PROBLEM 13-13 (Continued)

- (c) The financial statement presentation would be the same for both approaches used in parts (a) and (b).

Balance Sheet:**Current Assets:**

Inventory of Premiums (\$60,000 – \$34,500)	\$25,500
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Current Liabilities:

Estimated Liability for Premiums (\$57,600 – \$34,500)	\$23,100
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Income Statement:

Sales Revenue	\$1,800,000
Less: Premium Expense	57,600

(d)

Inventory of Premiums.....	60,000	
Cash		60,000
(To record purchase of 40,000 puppets at \$1.50 each)		

Cash	1,800,000	
Sales Revenue (480,000 X \$3.55)		1,704,000
Unearned Revenue.....		96,000
(To record sales of 480,000 boxes at \$3.55 each and unearned revenue of 480,000 X \$0.20 each)		

Estimated number of puppets to be
awarded: $(480,000 \times 40\%) \div 5 = 38,400$

Premium revenue per award: $\$96,000 \div 38,400 \text{ puppets} = \2.50

Cost per award: \$1.50 purchase cost

Premium Expense	34,500	
Inventory of Premiums		34,500
$(115,000 \div 5) = 23,000 \text{ puppets}$ 23,000 puppets X \$1.50 each = \$34,500		

PROBLEM 13-13 (Continued)

Unearned Revenue.....	57,500	
Sales Revenue.....		57,500
23,000 puppets awarded X \$2.50		
= \$57,500		

(e)

Balance Sheet:**Current Assets:**

Inventory of Premiums (\$60,000 – \$34,500)	\$25,500
---	----------

Current Liabilities:

Unearned Revenue (\$96,000 – \$57,500)	\$38,500
--	----------

Income Statement:

Sales revenue - cereal		\$1,704,000
Sales revenue - premiums	\$57,500	
Less: premiums expense	<u>34,500</u>	
Net premiums income		23,000

Alternatively, the two Sales amounts could be reported together and the cost of the premiums could be included in Cost of Goods Sold, along with the cost of the cereal.

(f)

Under the expense approach in part (c), total revenue recorded in 2014 is higher than under the revenue approach in part (e). However, the expense approach triggers a larger premium expense in 2014 because the full cost of providing the premium is estimated and recorded in 2014; whereas the premium expense recorded under the revenue approach represents only expenses incurred in the current period. In 2014, net income is higher under the expense approach than under the revenue approach. Current liabilities are higher under the revenue approach than under the expense approach, due to bifurcation

PROBLEM 13-13 (Continued)

of the sale proceeds between the product and the premium and deferral of the revenue related to the premium, under the revenue approach.

Customer loyalty programs are discussed in IFRIC 13, which requires that current sale proceeds be bifurcated between the original product sold and the award credits (as unearned revenue). Increasingly today, faithful representation and the asset and liability view of the financial statements drive the accounting model in favour of the revenue approach.

PROBLEM 13-14

(a) 2014

Inventory of Premiums.....	450,000	
Cash		450,000
(To record the purchase of 250,000 CDs at \$1.80 each)		

Cash	868,620	
Sales Revenue.....		868,620
(To record the sale of 2,895,400 candy bars at 30 cents each)		

Cash (\$480,000 – \$120,000)	360,000	
Premium Expense	72,000	
Inventory of Premiums (240,000 x \$1.80)		432,000
[To record the redemption of 1,200,000 wrappers, the receipt of \$480,000 (1,200,000 ÷ 5) X \$2.00, and the mailing of 240,000 CDs]		

Calculation of premium expense:		
240,000 CDs X \$1.80 each =	\$432,000	
Postage—240,000 X \$.50 =	120,000	
	\$552,000	
Less: Cash received—		
240,000 X \$2.00	480,000	
Premium expense for CDs issued	\$ 72,000	

Premium Expense	17,400*	
Estimated Liability for Premiums.....		17,400
(To record the estimated liability for premium claims outstanding at 12/31/14)		
*(290,000 ÷ 5) X (\$1.80 + \$.50 – \$2.00) = \$17,400		

PROBLEM 13-14 (Continued)**2015**

Inventory of Premiums.....	594,000	
Cash		594,000
(To record the purchase of 330,000 CDs at \$1.80 each)		

Cash	823,080	
Sales Revenue.....		823,080
(To record the sale of 2,743,600 candy bars at 30 cents each)		

Cash (\$600,000 – \$150,000)	450,000	
Estimated Liability for Premiums.....	17,400	
Premium Expense	72,600	
Inventory of Premium CDs (300,000 x \$1.80).....		540,000
(To record the redemption of 1,500,000 wrappers, the receipt of \$600,000 [(1,500,000 ÷ 5) X \$2.00], and the mailing of 300,000 CDs.)		

Calculation of premium expense:	
300,000 CDs X \$1.80 =	\$540,000
Postage—300,000 X \$0.50 =	<u>150,000</u>
	690,000
Less: Cash received—	
(1,500,000 ÷ 5) X \$2.00	<u>600,000</u>
Premium expense for CDs issued	90,000
Less: Outstanding claims at 12/31/14	
charged to 2014 but redeemed in 2015	<u>17,400</u>
Premium expense chargeable to 2015	<u>\$ 72,600</u>

Premium Expense	21,000*	
Estimated Liability for Premiums.....		21,000
*(350,000 ÷ 5) X (\$1.80 + \$.50 – \$2.00) = \$21,000		

PROBLEM 13-14 (Continued)

(b) Account	Amount		Classification
	2014	2015	
Inventory of Premiums	\$18,000¹	\$72,000²	Current asset
Estimated Liability for Premiums	17,400	21,000	Current liability
Premium Expense	89,400³	93,600⁴	Selling expense

$$^1 \quad \$1.80 \times (250,000 - 240,000)$$

$$^2 \quad \$1.80 \times (10,000 + 330,000 - 300,000)$$

$$^3 \quad \$72,000 + \$17,400$$

$$^4 \quad \$72,600 + \$21,000$$

(c) The Estimated Liability for Premiums is not a financial liability since it is an obligation to customers to provide a CD, not a contractual obligation to pay out cash or other financial assets. The fact that there is some cash amounts involved in its measurement does not make it a financial liability.

PROBLEM 13-15

(a)

1.	Sales of musical instruments and sound equipment	\$5,400,000
	Estimated warranty rate	<u>.02</u>
	Warranty expense for 2014	<u>\$ 108,000</u>
2.	Warranty liability —1/1/14	\$ 136,000
	2014 warranty expense (Requirement 1)	<u>108,000</u>
	Subtotal	244,000
	Actual warranty costs during 2014	<u>164,000</u>
	Warranty liability —12/31/14	<u>\$ 80,000</u>
3.	Coupons issued (1 coupon/\$1 sale)	1,800,000
	Estimated redemption rate	<u>.60</u>
	Estimated number of coupons to be redeemed	1,080,000
	Exchange rate (200 coupons for a CD player)	<u>÷ 200</u>
	Estimated number of CD players to be issued	5,400
	Net cost of CD players (\$34 – \$20)	<u>14</u>
	Premium expense for 2014	<u>\$ 75,600</u>
4.	Inventory of premiums—1/1/14	\$ 39,950
	Premium CD players purchased during 2014 (6,500 X \$34)	<u>221,000</u>
	Premium CD players available	260,950
	Premium CD players exchanged for coupons during 2014 (1,200,000/200 X \$34)	<u>\$ 204,000</u>
	Inventory of premiums—12/31/14	<u>\$ 56,950</u>
5.	Estimated liability for premiums—1/1/14	\$ 44,800
	2014 premium expense (Requirement 3)	<u>75,600</u>
	Subtotal	120,400
	Actual redemptions during 2014 [1,200,000/200 X (\$34 – \$20)]	<u>84,000</u>
	Estimated liability for premiums—12/31/14	<u>\$ 36,400</u>

PROBLEM 13-15 (Continued)

- (b) If the warranty and premium offers are considered revenue arrangements with multiple deliverables and the revenue approach is used to account for the warranties, a portion of the sales revenue from musical instruments and sound equipment, and recorded and sheet music will have to be deferred as unearned revenue. This revenue will be recognized over the term of the warranty period and premium offer period as revenue as coupons are redeemed and warranties are honoured. Management will need to determine what portion of the sales price represents revenue from warranties and premiums.**

When the musical instruments and sound equipment are sold, a portion of the sales price will be credited to Unearned Warranty Revenue. For the premiums, a portion of the recorded and sheet music sales will be credited to Unearned Revenue.

As warranties are claimed a portion of the Unearned Warranty Revenue will be earned and will be transferred to the income statement. Actual warranty costs will be recorded as warranty expense.

As coupons for premiums are redeemed, a portion of the Unearned Revenue will be earned and will be transferred to the income statement. The premium expense (or cost of premium) will be transferred to the income statement.

PROBLEM 13-16

(a)		
Cash	30,000	
Unearned Guarantee Revenue		30,000
 Accounts Receivable	 15,000	
Cash		15,000
 Unearned Guarantee Revenue	 10,000	
Guarantee Revenue.....		10,000
(\$30,000 ÷ 3)		
 Loss on Guarantee*	 30,000	
Liability for Guarantee		30,000

* This entry is based on management's determination of the likelihood of loss in providing guarantees for Hutter. Since the collateral for the loan involves rights on unproven technology, it appears that the possibility of loss is likely. Accounts receivable was not debited since Dungannon have not yet made payment on Hutter's debt. They do not have a balance owing from Hutter.

The Guarantee Revenue has been recognized on a straight-line basis. Company management may consider another basis more appropriate, such as an amount proportionate to the amount of debt being covered by the guarantee.

Dungannon will also need to assess the collectibility of the account receivable and include it in its bad debt expense and allowance for doubtful accounts determination as part of its adjusting entries. In particular, since the additional exposure to loss of \$30,000 for Hutter's liabilities involves rights on unproven technology, the estimate of bad debt expense on the outstanding receivable appears likely.

PROBLEM 13-16 (Continued)

(b) Dungannon needs to disclose the following information relating to its guarantees:

- **The nature of the guarantee, how it arose, and circumstances that require the guarantor to perform under the guarantee;**
- **The maximum potential amount of future payments that the guarantor could be required to make, without any reduction for receivable amounts;**
- **The nature and extent of any recourse provisions or collateral held;**
- **The carrying amount of the liability, if any.**

Disclosure in Dungannon's notes:

The company provides guarantees to certain customers whereby the company assumes their long-term debt in the event of non-payment to their creditors. The guarantee arrangement covers a three-year period from the date of the agreement. The maximum potential amount of future payments that the Company could be required to make is \$XXXXX. The Company does not have any recourse provisions or collateral against the current and potential liabilities arising from these guarantees. The Company has made payments under the guarantee of \$15,000 and has accrued an additional \$30,000 for the same customer. The possibility of further loss from this customer cannot be determined at this point. All other customers under guarantee have honoured their debt arrangements and the Company believes the possibility of loss under guarantees to these other customers to be unlikely.

PROBLEM 13-17**(a) 1. (1) ASPE – Section 3290**

It is likely a loss and liability have been incurred and a reasonable estimate can be made of the amount. The loss and liability should be recorded as follows:

Litigation Expense	800,000	
Litigation Liability		800,000

Note to the Financial Statements

The company is a defendant in a personal injury suit for \$4,000,000. The company is charging the year of the accident with \$800,000 in estimated losses, which represents the amount the company estimates will likely be awarded.

(2) IFRS

IAS 37 would be similar to the ASPE standard except that under IAS 37, provisions are required for situations where it is “probable” or “more likely than not” that a present obligation exists. This is a somewhat lower hurdle than the “likely” required under ASPE. If the amount cannot be measured reliably, no liability is recognized under IFRS either; however, the standard indicates that it is only in very rare circumstances that this would be the case. If recognized, IAS 37 requires that the best estimate and an “expected value” method be used to measure the liability. This approach assigns weights to the possible outcomes according to their associated probabilities when measuring the amount of the provision, if a range of possible amounts is available.

PROBLEM 13-17 (Continued)**(a) (Continued)****2. (1) ASPE – Section 3290**

Because the cause for litigation occurred before the date of the financial statements and because an unfavourable outcome is likely and reasonably estimable, Hamilton Airlines should report a loss and a liability in the December 31, 2014, financial statements. The loss and liability might be recorded as follows:

Litigation expense.....	3,000,000	
Litigation Liability		3,000,000
(\$5,000,000 X 60%)		

Note to the Financial Statements

Due to an accident that occurred during 2014, the company is a defendant in personal injury suits totalling \$5,000,000. The company is charging the year of the casualty with management's best estimate for the total expected losses, which represents the amount the company estimates will finally be awarded.

(2) IFRS

IAS 37 would be similar to the ASPE standard with the same exceptions for IAS 37 as noted in part (a)(1)(2) above.

- (b)** Hamilton Airlines need not establish a liability for risk of loss from lack of insurance coverage itself. *CICA Handbook for Private Enterprises* Section 3290 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. IAS 37 would mirror the ASPE standards in this situation. The cause for a loss must occur on or before the balance sheet date for a loss contingency to be recorded. However, the fact that Hamilton is self-insured should be disclosed in a note.

CASES

See the Case Primer on the Student website, as well as the Summary of the Case Primer in the front of the text. Note that the first few chapters in volume 1 lay the foundation for financial reporting decision making.

CA 13-1 ABC AIRLINES

Overview

The company is in a highly competitive and risky industry. The economic environment over the past few years has caused many airlines to restructure or fold in the face of declining sales, increased competition, and falling seat prices. ABC has held its own by undergoing two restructurings, the most recent of which revolves around increases in network profitability and cutting costs. Even so, the company is in a very precarious position with a long-term debt to equity ratio of 3.2 to 1 and a current ratio of .6 to 1. Losses for the past two years have been significant at close to \$200 million each year.

Users of the statements will be existing creditors and shareholders who will be monitoring the liquidity of the company given the ratios identified above. Employees, who are also shareholders, will be watching the statements for information about financial and job stability. This is a private company and therefore there is no requirement to follow GAAP. Assume however that ASPE is a constraint due to the fact that but the users will want the most useful information. Note that as a private entity, the company may elect to follow IFRS. The company is interested in understanding any differences between IFRS and ASPE.

Management will be concerned with full disclosure of the situation, due to the liquidity issues which are apparent in the statements and yet will also be concerned with assuring the stakeholders that the company will continue to operate.

CA 13-1 (Continued)

Analysis and Recommendations

The issue here is accounting for the free flights. As already noted, these flights are similar to the Frequent Flyer Points.

One option is to treat them the same as the Frequent Flyer Points since they are, in substance, the same, i.e., the more you fly, the more free flights you earn. In this case, the company could defer revenues to cover the potential future flights. In essence, the full amount of revenues from the ticket sold includes the flight taken and a potential future flight. Although ASPE does not explicitly refer to these types of plans, IFRS explicitly deals with this in IFRIC 13 and requires accounting for the transaction as unearned revenue as part of a multiple element arrangement.

In the notes to the financial statements, the company assumes that there is a cost to providing these free flights, which must be accrued and matched with the revenues. The revenues in question would be the revenues from the paid flights that would be recorded in the current period. The cost of the free flights should be tied to the current revenues as they are seen as an inducement to buy tickets and are therefore like advertising costs. Also, the program creates a liability to the customers since, as the customers fly more, ABC has a duty to them that they cannot avoid and the event obligating the company is the fact that the customers have taken the flight. There is a measurement issue here since not all customers will complete the requirement for a free flight, i.e., five flights and, even if they do, not all customers will indeed take the free flight. The company does have some history with these types of programs and this might help provide evidence as to the amount although this is a new and different program. This treatment would not be used under IFRS as noted above.

CA 13-1 (Continued)

Another option is to note disclose the program only. This option would be based on the fact that there are minimal incremental costs for free flights. The plane will be flying anyway. In addition, it is difficult to measure how many people will earn and actually take these free flights. The only possible cost might be if a paying customer is bumped. Given increased competition, it is unlikely that the planes will always be full and ABC might protect itself against this by only allowing the free flights on certain flights that might not normally ever reach capacity. Note, however, that part of the latest restructuring strategy is to increase network profitability, which means filling up each plane. This might result in paying passengers being bumped in the future and therefore a real cost.

Conservative accounting (deferral of revenues) in this situation, along with full disclosure, would be prudent for the company.

INTEGRATED CASES

IC 13-1 ENVIROCOMPANY LIMITED

Overview

This is a public entity (shares trade on a public stock exchange) and therefore, the statements will follow IFRS. The shareholders may not want the problem overemphasized since it might drive the share price down. Employees will likely feel the same way since they could lose their jobs if the company were forced to close. Management might be reluctant to disclose too much for the same reasons, especially until they figure out an acceptable/feasible plan of action. Furthermore, any negative disclosures reflect poor stewardship. Potential investors, on the other hand, would want full disclosure in order to assess the risks before investing. Whatever is disclosed could be used against the company by the public “at large” in an effort to protect themselves and the environment and also by lawyers in any lawsuits.

Other users would be the government environmental agencies who might use the information against EL. The Board of Directors might resist disclosures that imply negligence or guilt since they might be held personally liable.

The controller will have to ensure transparency.

IC 13-1 (Continued)**Analysis and Recommendations**

Issue: lawsuit

Based on a traditional interpretation of GAAP, there is no liability for the pollutants until the company is sued. EL has no duty or responsibility to the person suing the company until it is proven in a court of law that EL is guilty. Likewise, until the person actually sues the company, and a court rules against the company, there is an opportunity to avoid the potential obligation (i.e., hire good lawyers, present a good defence). The event that potentially obligates the entity may be the act of polluting or the act of the person getting sick and, therefore, this may have already happened. However, as noted above, the obligation has not yet necessarily been established although the lawyers have acknowledged the potential for a class action suit. IFRS requires accrual of a potential loss if occurrence of a future event is probable (more likely than not) and measurable. It does not sound as if this is the case here.

Note: disclosure might be prudent; however, given that the person has only threatened to sue and has not actually done it, traditionally this would not be disclosed, as it is difficult to assess the probability that the person or others will actually sue. What about potential investors? Does management in all good conscience have to warn them? Given the increasing onus on Boards of Directors to take full responsibility for the actions of the company, should they disclose the problem in order to protect themselves?

Regarding the specific lawsuit threat, it is likely unnecessary to disclose it for the above-noted reasons (primarily the uncertainty and the fact that the loss from a potential lawsuit is not measurable). However, regarding the larger problem (i.e., the inescapable fact that the pollution is harmful), it could be argued that they should disclose. However, since the information will already be in the newspapers (i.e., the environmental studies are likely public and politicians are involved) and since the problem is industry-wide, chances are that there is no additional need to disclose anything further.

IC 13-1 (Continued)

In conclusion, no disclosure is required since, at best, the threatened lawsuit is a contingent liability and it could be argued that it is unlikely that the company will suffer a material loss from it, especially since EL's insurance will cover up to \$1 million. There is no reason to alarm people unless there is a real problem and no reason to overemphasize this episode to the point of putting the company out of business.

Issue: asset retirement obligation/impairment:

Little detail is given in the case regarding whether the company has an asset retirement obligation. Under IFRS, the company would have to accrue an obligation if there was a legal obligation or a constructive obligation. Similarly, although little information is given in the case, the company should consider whether the assets are impaired.

IC 13-2 LANDFILL LIMITED

Overview

LL is in the waste disposal business and as such environmental concerns increase the business risk. The company has many users of its financial statements. The bank, which financed the acquisitions, will use the statements to assess cash flows. The government might use the statements to assess whether the company is in compliance with regulations with respect to closure and post-closure activities, etc. The statements will also be used by existing and potential customers who will look to see if the company is stable and in compliance with environmental standards. A final user is the purchaser's lawyers who will use the statements to perhaps assess what the company is worth in terms of negotiating a potential settlement regarding the toxins that are leaking (since LL has guaranteed toxin-free land).

Even though the company is a private company, GAAP will likely be a constraint given the number of users of the information who will want reliable and relevant information. The company may use ASPE or IFRS and is interested in any differences between the two.

As the auditor, this is a new client and so the risk is greater especially given the number of users and the potential lawsuit. Care must be taken to ensure that conservative accounting is applied so as not to overstate income or net assets.

Analysis and recommendations

Issue: Asset retirement obligations/impairment

Since the government regulations require capping, closure, and post-closure activities, a legal obligation exists and a liability must be recognized as soon as measurable. The obligation would be measured at the best estimate of the expenditure required to settle the present obligation.

IC 13-2 (Continued)

It is also prudent to ensure that the liability is accrued since LL must pay for cleanup where toxins are found upon sale of land. There is an additional risk here since the land sold by the company recently has been found to contain toxins.

The amount would be added to the cost of the land. The treatment would essentially be the same under ASPE and IFRS however, the measurement might differ. Under ASPE, if there is a range of values, the company would pick the most likely estimate within the range unless this amount was not determinable in which case the lowest amount in the range would be accrued. Under IFRS, the amount would be measured at the probability weighted expected value.

Care should be taken to assess the existing landfill sites to ensure that the value is not impaired. The potential lawsuit represents a change in circumstances that might signal impairment.

IC 13-2 (Continued)

Issue: Depreciation

Depreciate sites	No depreciation
- The garbage sites have a life of 20 years (finite life). - Since they contribute to revenues, the cost should be allocated to the periods in which revenues are generated (matching). - Since varying amounts of garbage are dumped, perhaps a unit of production type method might be used. This will allow the costs to be better matched with the revenues generated. - Although the land holds its value, it is difficult to measure salvage value. - Given the potential liability for cleanup costs, the land may be worthless at the end of its life if the company does not manage the environmental issues properly. - The current lawsuit would support this.	- The land has historically held its value (as long as there are no toxins present) and therefore, an estimate of salvage value might be based on past land values. - Currently, it is in the best interest of the company to deal with environmental issues and ensure no toxins given that existing and future customers assess this on an ongoing basis. The bank will also watch for this since toxins will destroy the value. - The government will assess for compliance with regulations.

It might be more prudent to depreciate the land values. Environmental standards change (and are increasing) and therefore, given the potential liability if toxins are subsequently found, the value of the land could be wiped out.

IC 13-2 (Continued)

Issue: Potential liabilities relating to the land that has been sold

Disclose	Accrue
- The issue of toxins being discovered must at least be disclosed as it could be material. - The company has guaranteed that there are no toxins and has agreed to pay if there are. The existence of the toxins is yet to be proved. In addition, the purchase price has already been reduced for an estimate of these costs. - The question is also one of measurement. Given the early stages of the notification by the lawyers, it is unlikely that the company will be able to measure the potential cost. - Disclosing or accruing a specific amount might prejudice the company's position in terms of how much is owed to the purchaser.	- The company must reflect the potential costs in the financial statements and must try to estimate as the finding of toxins is very material to users (the bank, purchaser and potential customers). - Even though the purchaser has yet to prove the existence of toxins, it might be argued that the company has a constructive obligation (it works hard to signal that it is responsible and environmentally friendly). - IFRS requires accrual if the obligation is probable and ASPE requires accrual if it is likely. - Measurement may also differ under ASPE versus IFRS as noted above.

It would be more prudent to accrue the costs if they are measurable. The company should contact the lawyers and verify the status.

IC 13-3 CANDELABRA LIMITED

Overview

- Two major users (bank and pension company) and therefore GAAP is likely a constraint (as it will give the users greater assurance as to relevance and reliability)
- As a private company, may use IFRS as an accounting policy choice or ASPE – differences will be noted between the two
- Revenues steadily increasing – may be pressure to preserve trend
- Bondholders are key users and bond contains debt covenant – sensitive ratio since company is almost at the limit (debt/equity = < 2:1)
- Issued shares to fund – held by large pension company who will want to assess value of investment – key user
- The auditor may want to ensure full disclosure and conservative accounting

Analysis and recommendations

Issue: Bond – 100 years

This is clearly a liability since there is an obligation to deliver cash in the form of interest payments.

IC 13-3 (Continued)

Issue: Carbon credits

Recognize	Do not
- Represents an asset to the company since allows them to produce pollution without incurring a penalty. - Credits trade on a market therefore measurable value. - The credits given by the government are essentially government grants which should be reflected in the statements. - If recognized, is this a derivative instrument or not? If so, would value at fair value and gains/losses would be booked to income (note that this is getting ahead as derivatives are discussed in chapter 16). Note that the contracts meet the definition of a derivative since their value changes as the supply of carbon dioxide changes, little was paid for the credits upfront and they will likely be settled in future (IFRS). Under ASPE derivatives accounting would not apply since these are not exchange-traded futures and therefore are not covered by Section 3856)	- No cost to the company for the allocated credits. - Under the historical cost principle – would be no laid down cost. - Therefore valued at \$0. - It may be difficult to measure since the government established market place is informal and may not have many transactions.

These definitely represent an asset to the company and therefore, in the interests of transparency, the entity should recognize them. Since the credits trade on a market and meet the definition of a derivative,

they should be valued at fair value (measurable) if IFRS is followed.
Note that recognition of positive value will improve debt to equity

IC 13-3 (Continued)

ratio. If ASPE is followed, recognize the asset as a government grant but don't revalue it subsequently.

Issue: Cave

Capitalize costs	Expense
- Very valuable if feasible (future benefit). - Already storing carbon dioxide there on a test basis so could argue technically feasible. - Strong motivation to succeed here since produce lots of carbon dioxide and will otherwise have to pay to purchase carbon credits. Also – have committed a significant amount of funds to this project and so have a vested interest in its success and almost reaching the completion stages.	- Have not established feasibility yet per engineers. - This is clearly a matter of judgement and there is significant uncertainty. - There is no evidence that future benefits exist.

More conservative not to recognize as an asset yet as the engineers are the experts in terms of feasibility and they are suggesting that there is uncertainty.

Issue: Shares

Shares are redeemable but only at option of company – so there is no obligation to pay cash. Therefore shares are equity.

TIME AND PURPOSE OF WRITING ASSIGNMENTS

WA 13-1 (Time 30–40 minutes)

Purpose—to present the student with a comprehensive challenge in determining various liabilities and presenting findings in writing. Issues addressed relate to contingencies, warranties, litigation, and unethical behaviour on the part of management.

WA 13-2 (Time 30–35 minutes)

Purpose—to provide the student with the opportunity to define liability, to distinguish between current and long-term liabilities and to distinguish between financial and non-financial liabilities. The student must also think about instances when typical short-term items might not be classified as current.

WA 13-3 (Time 30–40 minutes)

Purpose—to provide the student with the opportunity to look at recording liabilities related to customer loyalty programs, onerous contracts and constructive obligations.

WA 13-4 (Time 20–25 minutes)

Purpose—to provide an opportunity for the student to discuss various employee benefit liability issues and to prepare the appropriate journal entries for the year end under ASPE and IFRS.

WA 13-5 (Time 15–20 minutes)

Purpose—to provide the student with an opportunity to understand the differences between ASPE and IFRS and the conceptual reasons for any differences.

SOLUTIONS TO WRITING ASSIGNMENTS**WA 13-1**

(a)

Memo prepared by: Ethical Accountant

Date: January 2015

ProVision Corporation
December 31, 2014**Issue 1: Recognition of Warranty Expense**

During June of this year, the company began the manufacture and sales of a new line of dishwasher. Sales of 100,000 dishwashers during this period amounted to \$50,000,000. These dishwashers were sold under a one-year warranty, and the client estimates warranty costs to be \$25 per appliance and that similar warranties are available for sale for \$75.

As of the balance sheet date, the company had paid out \$1,000,000 in warranty expenditures that was also the amount expensed in its income statement. No recognition of any further liability associated with the warranty has yet been made.

There are two alternatives to reporting warranties: the earnings approach and the revenue approach. (It is assumed that the revenue approach will be used by both ASPE and IFRS at this time.) Using the revenue approach, the sale of each dishwasher is a bundled sale which includes the dishwasher and the warranty service which will expire one year from the date of sale. Consequently, the revenue related to the warranty service must be deferred at the point of sale and is calculated to be \$7,500,000 (100,000 X \$75). The sales should have been reported as:

1. Cash/Accounts Receivable	50,000,000	
Sales.....		42,500,000
Unearned warranty revenue		7,500,000
(To record sale of 100,000 dishwashers and unearned warranty revenue)		

WA13-1 (Continued)**(a) (Continued) Issue 1**

2. Warranty Expense 1,000,000
 Cash, Inventory, Accrued Payroll..... 1,000,000
 (To record warranty costs incurred)
3. Estimated Liability Under Warranties 2,625,000
 Warranty Revenue 2,625,000
 [To record warranty revenue earned on 35,000 units (35,000 X \$75)]

Under the earnings approach, the entries would be:

1. Cash/Accounts Receivable 50,000,000
 Sales..... 50,000,000
 (To record sale of 100,000 dishwashers)
2. Warranty Expense 1,000,000
 Cash, Inventory, Accrued Payroll,..... 1,000,000
 (To record warranty costs incurred)
3. Warranty Expense 1,500,000
 Estimated Liability Under Warranties 1,500,000
 [To accrue estimated warranty costs (100,000 X \$25) – \$1,000,000]

As can be seen, the amounts to be reported on the income statement will be different under the two approaches:

	Revenue based approach	Expense based approach
Sales - Dishwashers	\$42,500,000	\$50,000,000
Sales – Warranty service	2,625,000	
Expenses - warranties	(1,000,000)	(2,500,000)
Net impact on income	\$44,125,000	\$47,500,000

WA13-1 (Continued)**(a) (Continued) Issue 1**

The revenue approach more accurately reflects the contract-based approach for revenue recognition, and more faithfully presents that resulting liabilities and assets as a result of the sale transactions as the liability on the balance sheet is reflected at the fair value of the services still to be provided. The earnings approach measures the liability as the estimated costs to provide the service, which will be less than the fair value of this service. Consequently, the liability is understated using this method.

Issue 2: Rental Charges of Retail Division Based on Retail Profits

In reviewing the estimates used for bad debts expense and warranty costs, I noticed an increase from previous years. Mr. Burt Wilson, ProVision's CEO had instructed the previous accountant to increase these estimates in order to keep the retail division's profits at \$475,000. Since a portion of the rental costs are based on retail profits in excess of \$500,000, the increase in estimates results in lower rent expense.

The increases in the estimates do not seem to be justified by changes in economic conditions, the credit-worthiness of customers, past experience, or changes to products.

I advise that the estimates be reduced to levels more consistent with those used in previous years unless they can substantially justify the new estimates. They should also record the additional expense and liability related to the rental costs.

WA13-1 (Continued)**(a) (Continued)**

Issue 3: Asset retirement obligation

The treatment of asset retirement obligations under ASPE and IFRS are different. In both cases, the present value of the estimated future cash flows has to be determined. In the case of ASPE, the dismantling of the equipment and any added costs that result from the production process are added to the cost of the asset, and amortized appropriately. Under IFRS, only the cost of dismantling the equipment is added to the capital cost. Any costs resulting from the production process are added to the cost of production and expensed through cost of goods sold. The present value of the dismantling costs at June 1, 2014 will be the present value of \$3 million due in 120 months, at 0.5% per month discount rate is $\$3,000,000 \times 0.54963 = \$1,648,890$.

Under ASPE, the journal entries required are as follows:

To record the dismantling costs related to the equipment and the asset retirement obligation

Equipment.....	1,648,890	
Asset Retirement Obligation		1,648,890

To record the cleanup costs related to the production process and the asset retirement obligation at December 31, 2014

Present value of estimated clean up costs:

 Estimated cash flows $\$600,000/120 \times 7$ months = \$35,000

 Present value of \$35,000 to be paid in 113 months' time at 0.5% per month

$\$35,000 \times 0.56916$

Equipment.....	19,921	
Asset Retirement Obligation		19,921

WA13-1 (Continued)**(a) (Continued) Issue 3**

Dec 31, 2014

To record the depreciation on the equipment:

$$[(\$11,648,890 \times 7/120) + \$19,921]$$

Note: While the cost of the ARO that has been capitalized for the equipment as a whole is amortized over the full 120 months, the cost of the monthly clean-up costs should be recognized in the months the clean-up costs relate to. While these costs are recognized at their present value, the obligation will have to be accreted because the obligation for these costs will not be paid for another 113 months.

Depreciation Expense	699,440	
Accumulated Depreciation – Equipment		699,440

Dec 31, 2014

To record the accretion of the asset retirement obligation assuming there is no change in the estimate of cash flows, timing or discount rate. Present value at December 31, 2014 is:

$$\begin{aligned} &\text{Present value of \$3 million in 113 months at 0.5\%} \\ &= \$3,000,000 \times .56916 = \$1,707,480 \\ &\text{Accretion} = \$1,707,480 - \$1,648,890 \end{aligned}$$

Accretion Expense	58,590	
Asset Retirement Obligation		58,590

Note: The present value of the \$35,000 clean-up costs of \$19,921 is already at its Dec. 31, 2014 present value. Therefore the book value and PV of the ARO at Dec. 31/14 is now \$1,707,480 + \$19,921 = \$1,727,401. At Dec. 31/15, this total will be subject to accretion.

WA13-1 (Continued)**(a) (Continued) Issue 3**

Under IFRS, the journal entries required are as follows:

June 1, 2014

To record the dismantling costs related to the equipment and the asset retirement obligation

Equipment.....	1,648,890	
Asset Retirement Obligation		1,648,890

To record the cleanup costs related to the production process and the asset retirement obligation at December 31, 2014

Present value of estimated clean-up costs:

 Estimated cash flows $\$600,000/120 \times 7$ months = \$35,000

 Present value in 113 months' time at 0.5% per month

$\$35,000 \times 0.56916$

Production Overhead Costs.....	19,921	
Asset Retirement Obligation		19,921

(Note the production overhead costs would be either expensed in Cost of Goods Sold or included in inventory, depending on the number of dishwashers still in inventory.)

Dec 31, 2014

To record the depreciation on the equipment ($\$11,648,890 \times 7/120$)

Depreciation Expense.....	679,519	
Accumulated Depreciation – Equipment		679,519

WA13-1 (Continued)**(a) (Continued) Issue 3**

Dec 31, 2014

To record the accretion of the asset retirement obligation assuming there is no change in the estimate of cash flows, timing or discount rate. Present value at December 31, 2014 is:

Present value of \$3 million in 113 months at 0.5%

= \$3,000,000 X .56916 = \$1,707,480

Accretion = \$1,707,480 – \$1,648,890

Interest Expense	58,590	
Asset Retirement Obligation		58,590

As can be seen, the amounts to be reported on the income statement will likely be the same under the two approaches. Because the clean-up costs incurred for the 7 months carry no future benefit to the company, they should be recognized in depreciation expense under ASPE for the 7 month period. The depreciation expense will likely be charged as a component of production/conversion costs and then be allocated between inventory and cost of goods sold.

	ASPE	IFRS
Depreciation expense	\$699,440	\$679,519
Interest expense		58,590
Accretion expense	58,590	
Production overhead costs (may be partially expensed or inventoried)		19,921

WA13-1 (Continued)**(a) (Continued)**

Issue 4: Litigation

Loss Contingency on
Patent Infringement Litigation

Under ASPE, the contingent liability is recognized if it is “*likely*” to occur and can be reliably measured. In this case, since the lawsuit is still pending and has been assessed as “*more likely than not*”, this is not quite as high as “*likely*”. As a result, under ASPE, there would be no liability recognized, but note disclosure would be required.

Because the likelihood of loss is not determinable, it must be disclosed in the notes to the financial statements. This note should include a discussion of this pending litigation along with the lawyer’s assessment that the likelihood of loss is not determinable. In addition, the estimated amount of this loss contingency should also be disclosed.

Under IFRS, the current treatment is different. Since the threshold of *more likely than not* has been met, the next step is to reasonably estimate the amount, using expected probabilities. Using the information in the question, the best estimate would be calculated as follows:

$$(20\% \times \$5 \text{ million}) + (35\% \times \$3 \text{ million}) + (45\% \times 0) = \$2.05 \text{ million}$$

A liability for \$2.05 million would be accrued as follows:

Lawsuit Loss	2,050,000	
Lawsuit Liability.....		2,050,000

WA13-1 (Continued)

- (b) For issues 1, 3 and 4, it is difficult to determine whether the issues relate to errors on the part of management or from unethical behaviour. For issue 2 however, the increase in estimates is clearly unethical and is meant to decrease rental costs by showing lower profits. The benefits of this type of behaviour are short-term in nature and will cause long-term difficulties for the company. The trend of higher estimates cannot be maintained indefinitely. The results can include losing the rental location, civil action against the company, as well as criminal action for fraudulent behaviour. In addition, the current shareholders are harmed because the lower net income reduces the current value of their holdings.

WA 13-2

- (a) Under ASPE and existing IFRS, a liability is defined as “obligations of an enterprise arising from past transactions, the settlement of which may result in the transfer of assets.” In other words, it has three essential characteristics including: there is a responsibility to transfer assets, this duty cannot be avoided, and the event causing the obligation to arise has occurred.

The proposed definition of a liability under IFRS’s conceptual framework is that a liability is a present current obligation for which the entity is the obligor. Encompassed in this definition are essential characteristics including: a liability exists at the present time, and represents an enforceable obligation for the entity.

- (b) Under IFRS, the definition of current liabilities are “obligations whose liquidation will place a demand on the entity’s current assets and must be settled within the next 12 months from the report date, or the company’s operating cycle (if longer than 12 months); are held for trading purposes; or for which the entity does not have an unconditional right to defer payment beyond the next 12 months. Although ASPE does not have a definition of current liabilities, the examples provided in the standards meet a similar definition as provided for IFRS.
- (c) A financial liability under ASPE and IFRS is any liability that is a contractual obligation to deliver cash; or to exchange financial instruments with another party under conditions that may not be favourable for the entity. The key word here is that the financial liability results from a contractual agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law. Contracts, and thus financial instruments, may take a variety of forms and need not be in writing.

WA 13-2 (Continued)**(c) (Continued)**

Non-financial liabilities relate to obligations that will not be settled in cash, but instead with the provision of goods or services such as warranty obligations, asset retirement obligations, and unearned revenue. Under IFRS, these non-financial liabilities, at each reporting period, are measured at their best estimate of what the entity would have to pay to settle the obligation using present values and the expected probability of various outcomes. ASPE does not provide any general guidance on non-financial liabilities, but discusses each type under specific standards, where different measurement bases could be used. The various methods include: the fair value of goods and services to be delivered; the cost of the goods and services to be delivered or management's best estimates.

(d)

1. Generally, accounts payable would be classified as a current liability. In this case, since the due date is January 2015, the amount would be classified as a current liability.
2. Since the notes payable are due in more than one year from the balance sheet date, they would generally be reported as non-current liabilities. If there is any portion of the amount that will be required to be paid within the next 12 months, this amount would show as a current liability.

WA 13-2 (Continued)**(d) (Continued)**

3. 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 \$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, if longer). In addition, if there is a long period of time between the deposit and the delivery, then the deposit would be recorded at net present value under IFRS. Under ASPE, the fair value of this unearned revenue would be used.
4. Salaries payable is an accrued liability that in almost all circumstances would be reported as a current liability.
5. This bond is due in the next 12 months and should be reported as a current liability. Under IFRS, there is no unconditional right to defer at December 31, 2014, since the agreement was not signed before the report date. This could be disclosed in a subsequent event note, but the amount due would be reported as current.

This treatment would be different under ASPE. For this bond payable to qualify for exclusion from current liabilities, the company must meet the following criteria:

- (a) It must intend to refinance the obligation on a long-term basis, and
- (b) It must demonstrate an ability to consummate the refinancing.

WA 13-2 (Continued)**(d) (Continued)**

The second criteria, ability to refinance, can be demonstrated either by actually refinancing before the balance sheet is issued or by entering into a non-cancellable financing agreement, which has not been violated, with a capable lender. Only that portion of the bonds payable that has been refinanced can be reclassified. In this case, the entire amount of the bonds payable was refinanced prior to the issue date of the report, and therefore, the company could show the full amount of the bonds payable as a non-current liability.

WA 13-3

1. The customer loyalty program represents an obligation for the company. Under IFRS, each sale has multiple deliverables that include not only the good sold, but also the value of the points awarded. The fair value of the points must be recognized as unearned revenue until they are redeemed at some future date. Based on 700,000 points being awarded during the year, the amount of unearned revenue should have been \$350,000 (700,000 X \$0.50). The journal entry to record the sales for the year should have been:

Cash / Accounts Receivable	XXXX	
Sales.....		XXX
Unearned Revenue – Loyalty Program.....		350,000

At the end of the year, 80,000 points have been redeemed, when the company anticipated that 90% of 700,000 would be redeemed eventually. Consequently the amount of the revenue to be recorded is:

$$[80,000 / (700,000 \times 90\%)] \times \$350,000 = \$44,444$$

The journal entry to record the amount of earned revenue for the loyalty points to be recorded is:

Unearned Revenue – Loyalty Program.....	44,444	
Revenue – Customer Loyalty Program		44,444

The treatment under ASPE would be similar to the above.

2. The second issue is an onerous contract. The company is no longer gaining any benefits from the lease of this retail location since the store has been closed. However, it still has to make payments on the lease until March 1, 2016. The company has a legal obligation to continue to make the payments under the lease agreement, and these payments are unavoidable costs. The landlord is likely to accept a lump sum payment now equal to the present value of the remaining lease payments. Under IFRS, the liability must be recognized and measured at the present value of the unavoidable payments that must be made. At January 31, 2015, the company has 14 payments left from February 1, 2015 to March 1, 2016.

The present value of these annuity due payments is: \$2,300 each month, for 14 months at an interest rate of 0.5% per month = \$31,179 (found using a financial calculator).

The journal entry required is:

Lease Payments – Onerous Contract Loss	31,179	
Lease Contract Liability.....		31,179

WA 13-3 (Continued)

Under ASPE, onerous contracts are not specifically addressed; but practice has been to recognize the liability and the loss based on the fact that the entity has an obligation to pay for something that provides no future benefit to the entity.

3. This last issue is a constructive obligation. The company has made a practice of giving refunds to dissatisfied customers. Under IFRS, an estimate of this liability must be made at the fiscal year end using management's best estimate. When a provision relates to a large population of items, then the expected outcome is all the possible outcomes weighted by their probabilities as follows:

For the sales made in the 2015 fiscal year, the expected amount of returns will be: $(25\% \times 6\%) + (55\% \times 4\%) + (20\% \times 2\%) = 4.1\%$ of total sales. Since total sales in the fiscal year were \$35 million, the expected returns are:

$$\$35,000,000 \times 4.1\% = \$1,435,000$$

Since there was \$1,100,000 refunds already made, this leaves \$335,000 estimated to still be refunded. Therefore the refund liability should be recorded for \$335,000 as follows:

Loss on Refunds on Sales	335,000	
Estimated Liability for Refunds on Sales.....		335,000

Under ASPE, this constructive obligation would also be required to be recognized.

WA 13-4**Item 1**

The sick leave is an accumulated benefit that vests with the employees since the employee is entitled to a cash equivalent if the benefit has not been taken by the end of the next year. This obligation arises as the employee provides a service to the company and therefore must be accrued at December 31, 2014. Under IFRS, the amount of the obligation is “the additional amount that the entity expects to pay as a result of the unused entitlement that has accumulated at the end of the reporting period” (IAS 19.14). For this case, the 3% increase has already been agreed to so the expected amount would include this increase and the best estimate would be calculated as follows:

$$60 \text{ days} \times \$250 \text{ per day} \times 103\% = \$15,450$$

The following journal entry would be required on December 31, 2014

Employee Benefits / Wages Expense	15,450	
Sick Pay Wages Payable		15,450

ASPE does not provide any specific guidance on this type of benefit except that a liability arises from past transactions and requires the settlement in the future with a possible transfer of assets. Established practice would record similar amounts as under IFRS.

Item 2

Parental leave is a non-accumulating benefit and only arises when an event takes place. In this case, the employee who has already started maternity leave on December 15 is entitled to the benefit and any obligation of this benefit to be paid in 2015 will be accrued at December 31, 2014. The amount of this obligation is:

$$\$1,000 \times 11.5 \text{ months} = \$11,500.$$

The journal entry is:

Employee Benefits Expense	11,500	
Parental Leave Benefit Payable		11,500

For the other employee, the adoption has not yet taken place, and therefore the event has not occurred. There will be no obligation to set up for this employee until the time of the adoption and the parental leave commences.

IFRS and ASPE treatment would be the same for these benefits.

WA 13-4 (Continued)**Item 3**

This bonus is payable at December 31, 2014, since it relates to compensation that was earned during 2014. The total amount of the bonus is \$2 million X 3% = \$60,000. This equates to:

Managers – 30% X \$60,000 = \$18,000

Non-managers – 70% X \$60,000 = \$42,000. For each non-manager, the bonus is $\$42,000 \div 40 = \$1,050$

However, there is a stipulation that the bonus will only be paid to employees who are still working for the company on October 31, 2015 – 10 months from now. As a result, the best estimate of the liability would take into the consideration the turnover that is expected to occur over the next 10 months.

With the estimated turnover of 5%, this means that only 38 employees (40 X 95%) would still be employed by the company by the payout date.

Therefore, the best estimate of the payment to non-managers will be: $38 \times \$1,050 = \$39,900$.

Therefore, the total bonus payable is: $\$18,000 + \$39,900 = \$57,900$

The journal entry required for the bonus payable will be:

Compensation Expense	57,900	
Bonus Payable.....		57,900

WA 13-4 (Continued)**Item 4**

The vacation payable is an accumulating benefit that vests since the employee is entitled to this amount. However, the legal entitlement is only 2 weeks, and the additional amount of 1 week is a constructive obligation. Currently, the 10 employees are still owed 2 weeks' vacation (having taken 1 week already during the year). Under IFRS, the entire 2 weeks would be reported as an obligation at December 31, 2014, but adjusted for the probabilities related to all employees being entitled to this full amount. Based on the information, this would be calculated to be:

$$[10 \text{ employees} \times 5 \text{ days} \times 250 \times 103\%] + [(10 \text{ employees} \times 85\%) + (9 \text{ employees} \times 15\%)] \times 5 \text{ days} \times \$250 =$$

$$\$12,875 + \$12,682 = \$25,557$$

The journal entry required would be:

Wages Expense	25,557	
Vacation Wages Payable.....		25,557

Under ASPE, this type of constructive obligation would also be recorded as is the normal business practice.

Item 5

This is a contingent obligation. It appears that settlement will "more likely than not" be required, and that the obligation arose from a past event. The employee is asking for \$62,500 (25 years X 10 days X \$250/day). Consequently, some amount must be reported at December 31, 2014.

Under IFRS, a probability weighted expected value is determined. Using the estimates provided by the lawyer, this amount is estimated to be:
 $(25\% \times \$20,000) + (60\% \times \$28,000) + (15\% \times \$30,000) = \$26,300.$

The estimated obligation would be recorded as follows:

Employee Wages - Lawsuit Loss	26,300	
Lawsuit Liability.....		26,300

WA 13-4 (Continued)**Item 5 (Continued)**

In addition, note disclosure of the pending lawsuit would be required, indicating that a loss of \$56,300 had been recognized as the best estimate of the outcome.

Under ASPE, this contingency appears to be likely and it will require some amount of settlement based on the estimates provided by the lawyer. However, the amount to be recorded is either the best estimate within a range if it can be determined, or the lowest of the ranges of possible outcomes if no one amount is any more likely than any other. In this case, the range of settlements is \$20,000 to \$30,000. Assuming a best estimate could be determined to be \$28,000, based on the information given in the question this would be used to measure the liability.

The estimated obligation would be recorded as follows:

Employee Wages - Lawsuit Loss	28,000	
Lawsuit Liability		28,000

Similar note disclosure as under IFRS would be required under ASPE.

WA 13-5

There are many differences between IFRS and ASPE with respect to measurement and reporting for liabilities. Primarily, ASPE has been written to keep recognition and measurement issues simple and therefore requiring less cost and time to calculate and report. It also has a variety of ways of measuring non-financial liabilities, depending on how the liabilities arise. These are based on past practices used in Canada, and have not been changed on adoption of ASPE. Finally, ASPE has been designed with the creditor as the primary user in mind, rather than outside shareholders and creditors. Given that creditors generally have access to management, the disclosure has also been simplified.

These differences are highlighted below:

- Differences in terminology – IFRS uses the term “provision” to mean an obligation of uncertain timing and amount and a contingent liability refers to conditional obligations that are not recognized. Provisions are recognized if it is “more likely than not” to occur. Under ASPE, a contingent liability refers to conditional obligations and may be recognized in situations where it is “likely” to require an outflow of economic benefits in the future. The term provision under ASPE is not used in reference to liabilities.
- ASPE does not have a specific standard to address non-financial liabilities – these are considered in various standards as the need arises. As a result, the measurement of these non-financial liabilities is different ranging from fair value to costs of the goods and services to be provided. Also, although IFRS has a specific standard on customer loyalty payments, there is no explicit standard under ASPE.
- Only legal obligations are recognised under ASPE for asset retirement obligations – whereas IFRS would recognize legal and constructive obligations. One reason for this is to reduce the costs of preparation of private company financial statements in trying to determine constructive obligations related to asset retirement obligations. (Note that for other forms of liabilities, ASPE would recognize legal, constructive or equitable obligations).

WA 13-5 (Continued)

- For asset retirement obligations, all retirement costs related to the equipment or the production process are capitalized to the related capital assets. The primary reason for this is again to simplify the tracking of these costs without having to determine specifically how these costs arose. Under IFRS, the costs related to production processes are considered product costs and charged to inventory and costs related to the capital assets are capitalized.
- Measurement of non-financial liabilities has also been simplified under ASPE in comparison with IFRS. Under ASPE, the most likely value is used. In the case of a contingent liability, the best estimate within a possible range of values is used or the lowest value in the range. Under IFRS, probabilities and expected values must be determined and a probability weighted average value is used.
- Presentation of long term debt coming due (either because of maturity or violation of the agreement) is also different. Under ASPE, if an agreement to refinance can be accomplished prior to the issue date of the statements, then this debt can be reported as non-current. However, under IFRS, this refinancing agreement would have to be in place prior to the report date in order to show the debt as long term. This difference is following normal accepted past practices established in Canada prior to conversion to IFRS or ASPE.
- IFRS requires far more extensive disclosure of provisions, including reconciling opening and closing balances for each type of provision. ASPE does not require this disclosure – again to reduce costs in preparation of the financial statements.

RESEARCH AND FINANCIAL ANALYSIS**RA13-1 Shoppers Drugmart Corporation**

- (a) The current liabilities of Shoppers Drugmart Corporation at December 31, 2011, are detailed below.

		2011
(\$Canadian thousands)		Balance
Bank indebtedness		\$ 172,262
Accounts payable and accrued liabilities		1,109,444
Income taxes payable		26,538
Dividends payable		53,119
Current portion of long-term debt		249,971
Provisions		12,024
Associate interest		<u>152,880</u>
Total current liabilities		<u><u>\$ 1,776,238</u></u>

- (b) Provisions (note 3 (t)) are legal or constructive obligations that result from past events and it is probable that the obligation will be settled with a future outflow of economic benefits, and if it can be measured reliably. If the time value of money is material, the provisions are discounted using a pre-tax discount rate that takes into account the risks associated with the liability. Provisions are reviewed on a regular basis and adjusted to reflect best estimates. Provisions for Shoppers include insurance claims, litigation claims and store closing costs.
- (c) Shoppers' current ratio and quick ratio for each period presented are calculated below. The company's liquidity, based on these ratios, has decreased over the prior year based on the current liability, but the quick ratio has been quite stable. The inventory is a large component of the current assets (76%), so it is less likely that the quick ratio and current ratio will move in the same direction (as compared to some companies). Although there is an increase in current assets, current liabilities have also significantly increased, resulting in reduced liquidity. The largest change in the current assets is due to an increase in inventory, while current liabilities increased mainly due to an increase in the current portion of long-term debt.

RA13-1 Shoppers Drugmart Corporation. (Continued)

In general, a quick ratio of more than 1 to 1 indicates that the company should have no problem meeting its current obligations as they come due. However that depends on the industry. Shoppers should be compared to other retailers, and ideally those with a similar product mix, to assess the adequacy of their liquidity. While Shoppers' liquidity decreased relative to the prior year, it remains better than the liquidity 2 years ago.

In US \$ thousands	December 31, 2011	January 1, 2011	January 3, 2010
Current assets	2,695,647	2,542,820	2,441,973
Quick assets	611,904	516,827	515,326
Current liabilities	1,776,238	1,527,567	1,706,541
Current ratio	1.52	1.66	1.43
Quick ratio	0.34	0.34	.30

RA13-2 CANADIAN TIRE CORPORATION LIMITED.

(a) Canadian Tire's current liabilities include the following amounts:

	2010
(\$ millions)	Balance
Bank indebtedness	\$124.8
Deposits	1,182.3
Trade and other payables	1,640.9
Provisions	191.9
Short-term borrowings	352.6
Loans payable	628.7
Income taxes payable	3.9
Current portion of long-term debt	<u>27.9</u>
	<u>\$1,999.7</u>

"Trade and other payables" includes liabilities such as deferred revenue and derivatives. It probably mainly relates to regular trade accounts receivable, but it is possible that the accrued liabilities would include items like wages and salaries payable, GST and sales taxes payable, dividends payable, vacation pay accruals, and interest payable.

RA13-2 CANADIAN TIRE CORPORATION LIMITED. (Continued)

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

\$ In millions	2011	2010
Current assets	6,956.6	6,549.2
Current liabilities	4,153.0	3,251.5
Working capital	2,803.6	3,297.7

$$(2) \quad \text{Acid-test ratio} = \frac{\text{Cash + short-term investments + trade and other receivables + loans receivable}}{\text{Current liabilities}}$$

$$2011: \quad 1.26 \text{ times} = \frac{\$325.8 + \$196.4 + \$673.9 + 4,051.0}{\$4,153.0}$$

$$2010: \quad 1.75 \text{ times} = \frac{\$568.0 + \$196.7 + \$829.3 + 4,081.7}{\$3,251.5}$$

$$(3) \quad \text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

$$2011: \quad 1.675 \text{ times} = \frac{\$6,956.6}{\$4,153.0}$$

$$2010: \quad 2.01 \text{ times} = \frac{\$6,549.2}{\$3,251.5}$$

RA13-2 CANADIAN TIRE CORPORATION LIMITED. (Continued)

(4) Five year history:

	2011	2010	2009	2008	2007
Current assets	6,956.6	6,549.2	6,893.0	3,979.0	3,138.2
Current liabilities	4,153.0	3,251.5	3,971.9	1,999.7	2,113.7
Working capital	2,803.6	3,297.7	2,921.1	1,979.3	1,024.5
Current ratio	1.675	2.01	1.74	1.99	1.48

Canadian Tire Corporation's liquidity is good in general, since it has sufficient current assets to meet current liabilities. Its sound working capital position is reflected in its acid-test and current ratio. Its acid-test ratio also indicates that the company has a high proportion of liquid current assets. However, its liquidity has been fluctuating for the last 5 years. The working capital and the current ratio had increased in 2010, but had been at lower levels for 2011, 2009 and 2007 compared to 2010 and 2008.

$$(4) \text{ Inventory turnover} = \frac{\text{COGS}^*}{\text{Average inventory}}$$

$$2011: \quad 5.89 \text{ times} = \frac{\$6,916.7}{(\$1,448.6 + \$901)/2}$$

* from note 33 of financial statements.

The inventory and receivables tend to be a large proportion of the current assets used when assessing liquidity using working capital and the current ratio. Calculating the turnover of inventory provides information about the quality of this current asset.

The inventory turnover provides information about the saleability of the inventory and the number of days it takes to sell. A turnover of 5.89 times represents an average of 62 days that the inventory is held before being sold. The company sells many different types of inventory items, and the turnover figure calculated is an average for all inventories. Calculating the amount over several years and comparing it to other companies in the same industry would provide more meaningful information. When making these comparisons, one must be careful that the numerator in the ratio calculation is consistent with that used above.

RA 13-2 CANADIAN TIRE CORPORATION LIMITED. (Continued)
(b) (Continued)

In the case of receivables, the company has several types of receivables including credit card (MasterCard) receivables and loans from dealers (see Notes 11 and 12). Most of these receivables do not arise from sales in Canadian Tire retail outlets, since the credit card can be used with various merchants. The loans from associates do not relate to sales. As a result, a meaningful accounts receivable turnover ratio cannot be calculated. However, the large amount of cash that will be collected from these receivables and loans aids in paying current liabilities and increases working capital and current ratios.

(c) Current portion of long-term debt: (all numbers in \$ millions)

This amount represents the portion of long-term debt that is payable from current assets in the coming year. The amount would include only the principal portion of the long-term debt and would not include interest payable during the coming year. In this case, the current portion amount of \$27.9 million includes amounts relating to finance lease obligations (23.6 million) and promissory notes (4.3 million).

If the company's long-term debt does not increase, the current portion of long-term debt will be \$655.8 in the 2012 balance sheet. This amount consists of \$600 of senior notes due in 2013, \$34.9 of subordinated notes payable, \$20.7 of finance lease obligations and \$0.2 of promissory notes due within one year. This information is disclosed in note 26 to the financial statements. The concern is the senior note coming due requiring a total payment of \$600 million. Will the company have the cash to pay this amount or will it try to refinance this debt? If the debt is refinanced, at what rate and terms will the company have to pay? This will have implications for the company in future years.

RA13-2 CANADIAN TIRE CORPORATION LIMITED. (Continued)**(d) Commitments and Contingencies:**

Note 41 discloses guarantees and commitments relating to the minimum annual lease payments for equipment and property under operating leases. The note outlines guarantees that the company has for certain franchisees and Dealers of PartSource and mentions indemnification regarding business and property dispositions, indemnification of lenders and agents under credit facilities, and other indemnification commitments.

Contingent liabilities are required to be recorded in the financial statements when the criteria for accrual are met. If the criteria are not met, note disclosure is required. In the case of the guarantees and letters of credit related contingencies, the company's management has determined that the potential loss would be minimal and thus has not recognized a liability in the financial statements. Similarly, with respect to the legal proceedings, the note in the financial statements of Canadian Tire states the "Company believes that each such proceeding constitutes a routine legal matter incidental to the business conducted by the Company and that the ultimate disposition of the proceedings will not have a material adverse effect on its consolidated earnings, cash flows, or financial position." Although this note does not contain detailed information describing each of the contingencies or the amount of potential liabilities, it does indicate that the total aggregate exposure to the Company relating to two class action suits against the Company was approximately \$24.4 million at the end of the 2011 fiscal year.

(e) Under Note 5 – Capital Management , the company has two key covenants to maintain:

- Net tangible asset coverage which is calculated as:

$$\frac{\text{Total assets} - \text{intangible assets} - \text{current liabilities (excluding current portion of long term debt)} - \text{employee benefits payable}}{\text{Total long term debt (including current portion)}}$$
- The company is also restricted on the amount of dividends and repurchases of shares that can be made.
- The company was in compliance with both of these covenants.

RA13-3 LUFTHANSA

(a) The current liabilities for Lufthansa are made up of the following amounts:

(in millions EUR)	2011	2011	2010	2010
	€	% of total	€	% of total
Other provisions	818	8.4	880	9.0
Borrowings	616	6.3	957	9.7
Trade payables and other financial liabilities	4,227	43.2	4,193	42.7
Liabilities from unused flight documents	2,359	24.1	2,389	24.3
Advanced payments received, deferred income and other non-financial liabilities	939	9.6	1,066	10.9
Derivative financial instruments	37	0.4	103	1.0
Effective income tax obligations	71	0.7	237	2.4
Liabilities related to assets held for sale	716	7.3	-	-
Total	9,783		8,271	

As can be seen from the table, the trade payables **and other financial liabilities**, and liabilities for unused flights represent the largest proportion of the current liabilities. The year over year comparisons on the percentages indicate that these percentages are fairly consistent from 2010 to 2011.

(b) The notes provide further disclosure of the types of obligations included in the accounts as indicated below.

Other provisions (note 38) includes: obligations under partial retirement contracts, other staff costs, onerous contracts, environmental restoration, legal proceedings, restructuring/severance costs, fixed price customer maintenance contracts, maintenance on operating lease aircraft, warranties, and other provisions.

RA13-3 LUFTHANSA (Continued)

Trade payables and other financial liabilities (note 43) includes: trade payables and other liabilities to affiliated companies, trade payables to other equity investments and trade payables to third parties, liabilities to banks, other financial liabilities to affiliated companies and other financial liabilities.

Advanced payments received, deferred income and other non-financial liabilities (note 44) includes: advance payments received (EUR 32 million), net debit balance of advance payments received and receivable for unfinished contracts (EUR 150 million), deferred income (EUR 329 million) and other non-financial liabilities (EUR 428 million).

Liabilities from unused flight documents, as outlined in note 2, are flights that have been sold, but not yet used. These coupons or tickets will be recognized as traffic revenue when used. Coupons that have not been used by the year end (and are unlikely to be used in future), are recognized as revenue, based on previous years' statistical data.

(c) Per Note 38, the other staff costs relate to employee benefit programs including: staff jubilee bonuses, variable payment options and obligations from other programs that are not detailed.

The environmental restoration obligations are estimated based on surveyor's reports and the clean-up is assumed to be fully completed within 10 years.

Note 44 provides more accruals related to employee benefits as follows:

- Outstanding holiday allowance and overtime EUR 217 million
- The current portion of fair value obligations under share based remuneration programs EUR 8 million.

(d) Note 38 also provides the reconciliation of the other provisions between the opening and closing balances (although it does not split between "current" and "long-term" portions). Below is the reconciliation of the opening and closing balance:

	EUR millions
Opening balance – December 31, 2010	1,524
Exchange rate differences	12
Utilization	-613
New or added provisions	600
Interest	41
Reversals	-48
Reclassifications/transfers	-120
Closing balance – December 31, 2011	1,396

RA13-3 LUFTHANSA (Continued)

(e) Currently, as explained in Note 2, the accumulated unused miles are accounted for based on IFRIC 13 Customer Loyalty Programmes using the deferred revenue method. Amounts are based on estimates of the extent they are likely to be used for flights by airlines in the Lufthansa group. Lufthansa measures these miles at fair value (rather than cost) under the deferred revenue method. Fair value is based on the amount that the air miles could be sold for separately (for miles related to the company's own flights), and based on the price per mile to be paid to the partners (for points collected relating to third parties). Miles accumulated on the company's own flights are included in deferred revenue, and points collected from third parties are shown under other non-financial liabilities. There were a total of 201 billion of "miles to be measured as of December 31, 2011". These resulted in deferred revenue of EUR 987 million and non-financial liabilities of EUR 620 million.

(f) As explained in Note 45, the company has contingent liabilities that include guarantees, bills of exchange and cheque guarantees totalling EUR874; warranty contracts of EUR 977 million and provisions of collateral for third parties totalling EUR 35 million. As discussed in Note 2, related provisions are only recognised if an obligation exists and is likely to lead to a cash outflow that can be reliably estimated.

(g) Current borrowings, totalling EUR 616 million, relate to the liabilities owed to the banks for EUR 285 million and leasing liabilities and other loans for EUR 324million. The remainder of current borrowings relate to bonds (EUR 7 million). See Note 40 for details.

RA13-4 RESEARCH TOPIC*Sample Solution*

Topic: Liability accruals on interim financial statements

International accounting principles use the approach that an enterprise should apply the same accounting policies in its interim financial statements as are applied in its annual financial statements. Therefore, an enterprise should apply the same criteria for recognizing and measuring a liability accrual at the end of an interim period as it does at the end of its fiscal year. This means liabilities are recognized when an enterprise has a present obligation as a result of a past event. It is probable that an outflow of economic benefits will be required to settle that obligation and a reliable estimate of the obligation can be made.

For example, if a year-end bonus is a legal obligation, or past practice makes the bonus a constructive obligation for which the enterprise has no realistic alternative but to make the payments and a reliable estimate of the amount of the obligation can be made, the bonus is accrued for interim reporting purposes.

Since this type of bonus is usually based on a contract and is short-term in nature, it is recorded in the accounting records and reported in financial statements at the amount of cash that is payable in the future.

The accounting standard that can be applied to this topic is *International Accounting Standard 34*, "Interim Financial Reporting".

IAS 34 mentions recognizing and measuring losses that require accounting estimates (e.g. inventory write-downs or restructurings). It states that if the estimate changes in a subsequent interim period of that financial year, the original estimate is changed in the subsequent interim period either by accrual of an additional amount of loss or by reversal of the previously recognized amount.

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