

Intermediate Accounting, Vol. 2, 2e (Lo/Fisher)
Chapter 11 Current Liabilities and Contingencies

11.1 Learning Objective 1

1) Which of the following characteristic is required for a liability under IFRS Framework?

- A) A past obligation.
- B) A present obligation.
- C) An unknown obligation.
- D) A future obligation.

Answer: B

Diff: 1

Skill: Concept

Objective: 11.1 Describe the nature of liabilities and differentiate between financial and non-financial liabilities.

2) Which of the following characteristic is required for a liability under IFRS Framework?

- A) Arises from a past obligation.
- B) Is a present obligation.
- C) Is an unknown obligation.
- D) Is a future obligation.

Answer: B

Diff: 1

Skill: Concept

Objective: 11.1 Describe the nature of liabilities and differentiate between financial and non-financial liabilities.

3) Which of the following characteristic is required for a liability under IFRS Framework?

- A) Arises from a past event.
- B) Arises from a non-financial transaction.
- C) Arises from a future transaction.
- D) Arises from a forecasted transaction.

Answer: A

Diff: 1

Skill: Concept

Objective: 11.1 Describe the nature of liabilities and differentiate between financial and non-financial liabilities.

4) Which of the following characteristic is required for a "liability" under IFRS Framework?

- A) Expected to result in the inflow of economic benefits.
- B) Expected to result in the inflow of economic benefits that are measurable.
- C) Expected to result in the outflow of resources embodying economic benefits.
- D) Expected to result in the outflow of economic benefits that are virtually certain.

Answer: C

Diff: 1

Skill: Concept

Objective: 11.1 Describe the nature of liabilities and differentiate between financial and non-financial liabilities.

5) Which of the following is correct about a "liability" under IFRS Framework?

- A) A future obligation arising from past events, the settlement of which is expected to result in an inflow of resources.
- B) A present obligation arising from past events, the settlement of which is expected to result in an inflow of resources.
- C) A past obligation arising from past events, the settlement of which is expected to result in an outflow of resources.
- D) A present obligation arising from past events, the settlement of which is expected to result in an outflow of resources.

Answer: D

Diff: 2

Skill: Concept

Objective: 11.1 Describe the nature of liabilities and differentiate between financial and non-financial liabilities.

6) Which is an example of a liability?

- A) The decision to borrow \$150,000 from the ABC Bank on January 15, 2013.
- B) Withdrawing \$10,000 from the operating line of credit on January 15, 2013.
- C) Selecting the supplier to provide the raw materials for the manufacturing process.
- D) Choosing the site for a future plant expansion from a list of several possible choices.

Answer: B

Diff: 2

Skill: Concept

Objective: 11.1 Describe the nature of liabilities and differentiate between financial and non-financial liabilities.

7) Which of the following is a financial liability?

- A) A magazine publisher's obligation to provide the magazine monthly for an agreed upon period.
- B) Warranties.
- C) Accounts payable.
- D) Income taxes payable.

Answer: C

Diff: 2

Skill: Concept

Objective: 11.1 Describe the nature of liabilities and differentiate between financial and non-financial liabilities.

8) What are "liabilities"? Differentiate between financial liabilities and nonfinancial liabilities.

Answer:

- Liabilities are present obligations of the entity arising from past events that are expected to result in an outflow of resources.
- Financial liabilities are contractual obligations that will be settled in cash or by transferring another financial asset to the creditor.
- A non-financial liability is an obligation that meets the definition of a liability but is not a financial liability. It is settled through the provision of goods or delivery of services—not by settlement in cash or another financial asset.

Diff: 1

Skill: Concept

Objective: 11.1 Describe the nature of liabilities and differentiate between financial and non-financial liabilities.

9) Why is it important to distinguish financial from non-financial liabilities?

Answer: IFRS requires that some financial liabilities be measured at their fair value rather than at amortized cost.

Diff: 1

Skill: Concept

Objective: 11.1 Describe the nature of liabilities and differentiate between financial and non-financial liabilities.

10) Explain the meaning of "provision" and give an example.

Answer: A provision is a liability for which there is some uncertainty as to the timing or amount of payment. It should be noted, that having uncertainty over the amount or timing of payments does not imply that a liability cannot be reliably measured. For example, payments for warranty costs are uncertain in terms of both amount and timing, yet we would still record a liability for the estimated cost of fulfilling warranties.

Diff: 1

Skill: Concept

Objective: 11.1 Describe the nature of liabilities and differentiate between financial and non-financial liabilities.

11) Explain some of the challenges that exist in determining the amount of a "liability" by identifying factors that influence the value of the indebtedness.

Answer: Factors include whether:

- the obligation is a financial liability or a non-financial liability;
- the market rate of interest is different from that recorded in the loan documentation;
- the market rate of interest has changed since the liability was incurred;
- there is uncertainty about the amount owed;
- the amount owed depends upon the outcome of a future event; or
- the obligation is payable in a foreign currency.

Diff: 2

Skill: Concept

Objective: 11.1 Describe the nature of liabilities and differentiate between financial and non-financial liabilities.

12) Which of the following is correct about a "liability" under IFRS Framework?

- A) A future obligation arising from current events, the settlement of which is expected to result in an outflow of resources.
- B) A present obligation arising from current events, the settlement of which is expected to result in an outflow of resources.
- C) A future obligation arising from past events, the settlement of which is expected to result in an outflow of resources.
- D) A present obligation arising from past events, the settlement of which is expected to result in an outflow of resources.

Answer: D

Diff: 2

Skill: Concept

Objective: 11.1 Describe the nature of liabilities and differentiate between financial and non-financial liabilities.

13) Which statement is correct under the IFRS definition for a "liability"?

- A) The obligating event must be probable before the liability can be recognized.
- B) The obligating event must be virtually certain before the liability can be recognized.
- C) A reliable measure of the obligation must exist before the liability can be recognized.
- D) A precise measure of the obligation must exist before the liability can be recognized.

Answer: C

Diff: 2

Skill: Concept

Objective: 11.1 Describe the nature of liabilities and differentiate between financial and non-financial liabilities.

14) Which statement regarding liabilities is **not** correct under the IFRS Framework?

- A) A reliable estimate for an asset is presumed to exist.
- B) A provision exists if the timing of payment is uncertain.
- C) A provision exists if the amount of payment is uncertain.
- D) A reliable estimate for a liability is presumed to exist.

Answer: A

Diff: 2

Skill: Concept

Objective: 11.1 Describe the nature of liabilities and differentiate between financial and non-financial liabilities.

15) Which statement is correct about financial and non-financial liabilities?

- A) A non-financial liability is a contractual obligation to deliver cash to another party.
- B) A non-financial liability does not meet all of the criteria for a "liability."
- C) The two liabilities may be valued differently for financial reporting purposes.
- D) A non-financial liability is measured at fair value rather than amortized cost.

Answer: C

Diff: 3

Skill: Concept

Objective: 11.1 Describe the nature of liabilities and differentiate between financial and non-financial liabilities.

16) Which is **not** an example of a non-financial liability?

- A) Warranty liability.
- B) Bank loan.
- C) Income taxes payable.
- D) Deferred revenue.

Answer: B

Diff: 3

Skill: Concept

Objective: 11.1 Describe the nature of liabilities and differentiate between financial and non-financial liabilities.

17) Which is **not** an example of a financial liability?

- A) Payment to supplier for raw material received.
- B) Obligation to repay a US dollar bank loan.
- C) Obligation under a finance lease.
- D) Obligation under a customer loyalty program.

Answer: D

Diff: 3

Skill: Concept

Objective: 11.1 Describe the nature of liabilities and differentiate between financial and non-financial liabilities.

18) Which is **not** a current liability?

- A) Accounts payable due in 120 days.
- B) Bank loan due in three years that is in default.
- C) Bonds payable maturing in five years.
- D) Certain held for trading liabilities.

Answer: C

Diff: 2

Skill: Concept

Objective: 11.1 Describe the nature of liabilities and differentiate between financial and non-financial liabilities.

19) What are the three broad categories of liabilities?

Answer: The three broad categories of liabilities are:

- 1. Financial liabilities held for trading
- 2. Other financial liabilities
- 3. Non-financial liabilities

Diff: 1

Skill: Concept

Objective: 11.1 Describe the nature of liabilities and differentiate between financial and non-financial liabilities.

20) Fill in the following chart.

	Initial measurement of the liability	Subsequent measurement of the liability
Non-financial liability		
Financial liability held for trading		

Answer:

	Initial measurement of the liability	Subsequent measurement of the liability
Non-financial liability	The initial measurement of non-financial liabilities depends on their nature.	Non-financial liabilities are subsequently measured at the initial obligation less the amount earned to date or satisfied to date through performance.
Financial liability held for trading	Fair value.	Fair value

Diff: 3

Skill: Concept

Objective: 11.1 Describe the nature of liabilities and differentiate between financial and non-financial liabilities.

21) Fill in the following chart.

	Initial measurement of the liability	Subsequent measurement of the liability
Non-financial liability		
Financial liability not held for trading		

Answer:

	Initial measurement of the liability	Subsequent measurement of the liability
Non-financial liability	The initial measurement of non-financial liabilities depends on their nature.	Non-financial liabilities are subsequently measured at the initial obligation less the amount earned to date or satisfied to date through performance.
Financial liability not held for trading	Other financial liabilities are initially reported at fair value minus the transaction costs directly resulting from incurring the obligation.	Other financial liabilities are subsequently measured at amortized cost using the effective interest method.

Diff: 3

Skill: Concept

Objective: 11.1 Describe the nature of liabilities and differentiate between financial and non-financial liabilities.

11.2 Learning Objective 2

1) Which statement is correct?

- A) HST payable is a financial liability.
- B) Bank overdraft is a non-financial liability.
- C) Unearned revenue is a non-financial liability.
- D) Unearned subscriptions are a financial liability.

Answer: C

Diff: 3

Skill: Concept

Objective: 11.2 Describe the nature of current liabilities, and account for common current liabilities including provisions.

2) Which is a non-current liability?

- A) HST payable.
- B) 45 day accounts payable.
- C) Five year loan that matures four months after year end reporting date.
- D) The creditor has granted a 15-month grace period on a loan in default.

Answer: D

Diff: 2

Skill: Concept

Objective: 11.2 Describe the nature of current liabilities, and account for common current liabilities including provisions.

3) Which statement is correct?

- A) Contingencies arise from future events.
- B) The amount to be paid for contingencies is known or reasonably estimable.
- C) Current liabilities arise from future events.
- D) The amount to be paid for current liabilities is known or reasonably estimable.

Answer: D

Diff: 1

Skill: Concept

Objective: 11.2 Describe the nature of current liabilities, and account for common current liabilities including provisions.

4) Why is it important to distinguish current liabilities from long-term liabilities?

Answer: It is important to distinguish current liabilities from long-term liabilities because financial statement users often need to know the total of current liabilities to assess the liquidity. The current ratio and the working capital ratio are the best indicators of liquidity. These two ratios require total current liabilities.

Diff: 1

Skill: Concept

Objective: 11.2 Describe the nature of current liabilities, and account for common current liabilities including provisions.

5) Which statement is correct?

- A) Supplier discounts can only be accounted for by using the gross method.
- B) The amount owing for trade payables is generally not known with a high degree of certainty.
- C) An accrued liability is needed when a company has received goods, but not the invoice.
- D) Completeness means that obligations are reported in the proper accounting period.

Answer: C

Diff: 2

Skill: Concept

Objective: 11.2 Describe the nature of current liabilities, and account for common current liabilities including provisions.

6) Which is a reason to use the net method to record purchase discounts?

- A) Cost-benefit factor is greater for the net method.
- B) Reporting "purchase discounts lost" signifies inefficient business practices.
- C) Given the materiality of the amounts involved, the net method is used.
- D) The net method is technically superior to the gross method.

Answer: D

Diff: 3

Skill: Concept

Objective: 11.2 Describe the nature of current liabilities, and account for common current liabilities including provisions.

7) Contrast the gross method with the net method of recording purchase discounts by completing the following table:

	For	Against
Net Method		
Gross Method		

Answer:

	For	Against
Net Method	The net method is supported by IAS 2 <i>Inventories</i> , which indicates that the cost of inventory should exclude trade discounts.	When the net method is employed and discounts are not availed of, entities must report a finance expense for "purchase discounts lost." Managers are loath to do this, as forgoing available discounts is usually considered a poor business practice.
Gross Method	It is much easier to record invoices at their face value and it can usually be justified on the basis of cost-benefit and materiality factors.	The gross method may be overstating purchases and payables if the discount is eventually taken.

Diff: 1

Skill: Concept

Objective: 11.2 Describe the nature of current liabilities, and account for common current liabilities including provisions.

8) Explain the nature of current liabilities and how these are accounted for in the financial statements.

Answer: Current liabilities are obligations that are expected to be settled within one year of the balance sheet date or the business's normal operating cycle, whichever is longer. Current liabilities are reported separately from non-current liabilities in the balance sheet unless they are presented in order of liquidity to provide more reliable and relevant information.

Diff: 1

Skill: Concept

Objective: 11.2 Describe the nature of current liabilities, and account for common current liabilities including provisions.

9) Explain the meaning of the following terms: current assets, trade payables, expected value, deferred revenue and warranty.

Answer: Current assets: Assets that are expected to be consumed or sold within one year of the balance sheet date or the business's normal operating cycle, whichever is longer. Also includes assets held primarily for trading purposes.

Trade payables: Obligations to pay for goods received or services used.

Expected value: The value determined by weighting possible outcomes by their associated probabilities.

Deferred revenue: A non-financial obligation arising from the collection of revenue that has not yet been earned.

Warranty: A guarantee that a product will be free from defects for a specified period.

Diff: 1

Skill: Concept

Objective: 11.2 Describe the nature of current liabilities, and account for common current liabilities including provisions.

10) For a \$100,000 trade payable with terms of 2/10, net 45, how much would be reported as "purchase discount lost" under the gross method if a payment was made after 60 days?

A) \$0

B) \$2,000

C) \$4,500

D) \$10,000

Answer: A

Diff: 2

Skill: Comp

Objective: 11.2 Describe the nature of current liabilities, and account for common current liabilities including provisions.

11) For a \$200,000 trade payable with terms of 2/15, net 50, how much would be reported as "purchase discount lost" under the net method if a payment was made after 60 days?

A) \$0

B) \$4,000

C) \$5,000

D) \$30,000

Answer: B

Explanation: B) $(200,000 \times 2\%)$

Diff: 2

Skill: Comp

Objective: 11.2 Describe the nature of current liabilities, and account for common current liabilities including provisions.

12) How are "purchase discounts lost" reported in the financial statements?

- A) As a reduction of sales.
- B) As an increase in liability.
- C) As an increase in inventory.
- D) As an expense item.

Answer: D

Diff: 2

Skill: Concept

Objective: 11.2 Describe the nature of current liabilities, and account for common current liabilities including provisions.

13) Which statement is correct?

- A) Trade payables are supported by a written promise to pay.
- B) Trade payables with no discount terms are expected to be paid in full.
- C) Notes payable are legally enforceable and can only be interest bearing.
- D) Notes payables are recognized at the face value or transaction price.

Answer: B

Diff: 2

Skill: Concept

Objective: 11.2 Describe the nature of current liabilities, and account for common current liabilities including provisions.

14) For the following transaction, provide all of the required journal entries from inception to liquidation.

Assume a December 31 year end and that the company does not prepare interim statements. Round all amounts to nearest dollar.

Face value of note payable	\$200,000
Date of issue for note	March 1, 2017
Due date for note	May 1, 2017
Interest rate in the note	0%
Market rate of interest	5%
Consideration received	Inventory

Answer:

Issuance

Dr. Inventory	200,000	
Cr. Note Payable		200,000

(record at original invoice amount since it is a short payable with no stated interest rate—a rule of thumb for notes less than 90 days. Additionally, discounting the note to fair value would not be material.)

Liquidation/Payment

Dr. Note payable	200,000	
Cr. Cash		200,000

Diff: 2

Skill: Comp

Objective: 11.2 Describe the nature of current liabilities, and account for common current liabilities including provisions.

15) Why are taxes payable not classified as financial liabilities?

Answer: The obligations to pay taxes are legislative in nature rather than contractual, hence they do not fit the definition of a financial liability as set out in IAS 32.

Diff: 2

Skill: Concept

Objective: 11.2 Describe the nature of current liabilities, and account for common current liabilities including provisions.

16) Which of the following is true about non-interest bearing notes?

A) The most common method of determining the fair value of non-interest bearing notes is the discounted cash flow analysis.

B) Non-interest bearing short-term payables may never be measured at the original invoice amount.

C) A rule of thumb is to use the face value for non-interest bearing notes payable with a duration of greater than 90 days.

D) A rule of thumb is to use the market value for non-interest bearing notes payable with a duration of 90 days or less.

Answer: A

Diff: 2

Skill: Concept

Objective: 11.2 Describe the nature of current liabilities, and account for common current liabilities including provisions.

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17) For the following transaction, provide all of the required journal entries from inception to liquidation. Assume a December 31 year end and that the company does not prepare interim statements. Round all amounts to nearest dollar.

Face value of note payable	\$200,000
Date of issue for note	March 1, 2016
Due date for note	March 1, 2017
Interest rate in the note	0%
Market rate of interest	5%
Consideration received	Machinery

Answer:

Issuance

Dr. Machinery	190,476	
Cr. Note Payable		190,476

(Discount to fair value: $200,000 / 1.05$)

At year end:

Dr. Interest expense	7,937	
Cr. Note payable		7,937

($190,476 \times 5\% \times 10/12$ month)

Liquidation/Payment

Dr. Interest expense	1,587	
Cr. Note payable		1,587

($190,476 \times 5\% \times 2/12$ month)

Dr. Note payable	200,000	
Cr. Cash		200,000

Diff: 2

Skill: Comp

Objective: 11.2 Describe the nature of current liabilities, and account for common current liabilities including provisions.

18) For the following transaction, provide all of the required journal entries from inception to liquidation. Assume a December 31 year end and that the company does not prepare interim statements. Round all amounts to nearest dollar.

Face value of note payable	\$200,000
Date of issue for note	May 1, 2016
Due date for note	May 1, 2017
Interest rate in the note	5%
	(interest due at maturity)
Market rate of interest	5%
Consideration received	Cash

Answer:

Issuance

Dr. Cash	200,000	
Cr. Note Payable		200,000

(face amount since note is interest bearing)

At year end:

Dr. Interest expense	6,667	
Cr. Accrued interest payable		6,667

($200,000 \times 5\% \times 8/12\text{month}$)

Liquidation/Payment

Dr. Interest expense	3,333	
Cr. Accrued interest payable		3,333

($200,000 \times 5\% \times 4/12\text{month}$)

Dr. Note payable	200,000	
Dr. Accrued interest payable	10,000	
Cr. Cash		210,000

Diff: 2

Skill: Comp

Objective: 11.2 Describe the nature of current liabilities, and account for common current liabilities including provisions.

19) Which is true about lines of credit?

- A) The company generally must repay the credit line in full monthly.
- B) The borrower can borrow up to an agreed upon limit.
- C) Interest is charged on the full amount of the agreed upon limit.
- D) Lines of credit are particularly useful for steady income businesses that have very little volatility in revenue.

Answer: B

Diff: 2

Skill: Concept

Objective: 11.2 Describe the nature of current liabilities, and account for common current liabilities including provisions.

20) Which statement about sales taxes is correct?

- A) The consumer is responsible for remitting the tax to the government.
- B) Taxes are uniformly applied to all sale transactions.
- C) Businesses can deduct the GST paid on their purchases from GST collected.
- D) The same products that are exempt from GST are exempt from PST.

Answer: C

Diff: 2

Skill: Concept

Objective: 11.2 Describe the nature of current liabilities, and account for common current liabilities including provisions.

21) Which statement about sales taxes is correct?

- A) Businesses can recover the PST paid on all of their purchases.
- B) Goods purchased for resale are exempt from PST.
- C) Businesses remit only the GST collected on sales transactions.
- D) The same products that are exempt from HST are exempt from PST.

Answer: B

Diff: 2

Skill: Concept

Objective: 11.2 Describe the nature of current liabilities, and account for common current liabilities including provisions.

22) A company, using a perpetual inventory system, sells goods on credit for \$10,000. The applicable PST rate is 5% and the cost of goods sold was \$6,000. Sales taxes are remitted on a monthly basis. Prepare the necessary journal entries for this transaction.

Answer:

Sale of goods

Dr. A/R	10,500	
Cr. Sales		10,000
Cr. PST payable (10,000 × 5%)		500

Dr. Cost of goods sold	6,000	
Cr. Inventory		6,000

Remit sales tax

Dr. PST payable (10,000 × 5%)	500	
Cr. Cash		500

Diff: 2

Skill: Comp

Objective: 11.2 Describe the nature of current liabilities, and account for common current liabilities including provisions.

23) A company, using a perpetual inventory system, sells goods on credit for \$10,000. The applicable PST rate is 5% and the GST rate is 10%. The cost of goods sold was \$6,000. Sales taxes are remitted on a monthly basis. Prepare the necessary journal entries for this transaction.

Answer:

Sale of goods

Dr. A/R	11,500	
Cr. Sales		10,000
Cr. PST payable (10,000 × 5%)		500
Cr. GST payable (10,000 × 10%)		1,000
Dr. Cost of goods sold	6,000	
Cr. Inventory		6,000

Remit sales tax

Dr. PST payable	500	
Dr. GST payable	1,000	
Cr. Cash		1,500

Diff: 2

Skill: Comp

Objective: 11.2 Describe the nature of current liabilities, and account for common current liabilities including provisions.

24) A company, using a perpetual inventory system, sells goods on credit for \$10,000. The applicable HST rate is 10%. The cost of goods sold was \$6,000. Sales taxes are remitted on a monthly basis. Prepare the necessary journal entries for this transaction.

Answer:

Sale of goods

Dr. A/R	11,000	
Cr. Sales		10,000
Cr. HST payable (10,000 × 10%)		1,000
Dr. Cost of goods sold	6,000	
Cr. Inventory		6,000

Remit sales tax

Dr. HST payable	1,000	
Cr. Cash		1,000

Diff: 2

Skill: Comp

Objective: 11.2 Describe the nature of current liabilities, and account for common current liabilities including provisions.

25) A company purchases inventory on credit for \$80,000. Inventory costing \$30,000 is sold on credit for \$40,000. The applicable HST rate is 10%. Sales taxes are remitted on a monthly basis. Prepare the necessary journal entries for this transaction.

Answer:

Purchase of inventory

Dr. Inventory	80,000	
Dr. HST recoverable (80,000 × 10%)	8,000	
Cr. A/P		88,000

Sale of goods

Dr. A/R	44,000	
Cr. Sales		40,000
Cr. HST payable (40,000 × 10%)		4,000

Dr. Cost of goods sold	30,000	
Cr. Inventory		30,000

Remit sales tax

Dr. HST payable	4,000	
Dr. HST receivable from government	4,000	
Cr. HST recoverable		8,000

Diff: 3

Skill: Comp

Objective: 11.2 Describe the nature of current liabilities, and account for common current liabilities including provisions.

26) A company purchases inventory on credit for \$40,000. Inventory costing \$30,000 is sold on credit for \$50,000. The applicable HST rate is 10%. Sales taxes are remitted on a monthly basis. Prepare the necessary journal entries for this transaction.

Answer:

Purchase of inventory

Dr. Inventory	40,000	
Dr. HST recoverable (40,000 × 10%)	4,000	
Cr. A/P		44,000

Sale of goods

Dr. A/R	55,000	
Cr. Sales		50,000
Cr. HST payable (50,000 × 10%)		5,000

Dr. Cost of goods sold	30,000	
Cr. Inventory		30,000

Remit sales tax

Dr. HST payable	5,000	
Cr. HST recoverable		4,000
Cr. Cash		1,000

Diff: 3

Skill: Comp

Objective: 11.2 Describe the nature of current liabilities, and account for common current liabilities including provisions.

27) List three reasons why the recording of sales taxes is **not** straightforward.

Answer:

1. Some products are exempt from PST and others are exempt from GST.
2. The regulations and rates in each province differ somewhat, including which products are exempt.
3. Businesses are generally permitted to deduct the GST and HST paid on their purchases from the GST and HST collected and to remit the net amount owing to the federal government.

Diff: 3

Skill: Concept

Objective: 11.2 Describe the nature of current liabilities, and account for common current liabilities including provisions.

28) Which of the following is true?

- A) The declaration of a stock dividend gives rise to a liability.
- B) Stock dividends are revocable by the board of directors at any time before they are issued.
- C) Undeclared dividends in arrears on cumulative preferred shares are recorded as a liability.
- D) No note disclosure is required for the declaration of a stock split.

Answer: C

Diff: 3

Skill: Concept

Objective: 11.2 Describe the nature of current liabilities, and account for common current liabilities including provisions.

29) List three characteristics of a franchise arrangement.

Answer: A franchise arrangement is one in which:

- A) the franchisor licences its trademark or business practices to the franchisee.
- B) the franchisee has the right to sell specified goods or services in a designated area.
- C) requires the franchisee to pay to the franchisor a royalty fee based on sales or some other metric.

Diff: 3

Skill: Concept

Objective: 11.2 Describe the nature of current liabilities, and account for common current liabilities including provisions.

30) What is true regarding royalty fees?

- A) Unpaid royalty fees are recorded as a contra asset.
- B) Unpaid royalty fees are a debit to royalty fee expense and a credit to unearned revenue.
- C) Royalty fees are a minor expense for publishing companies.
- D) A franchise gives the franchisor the right to sell specified goods and/or services within a designated area.

Answer: D

Diff: 3

Skill: Concept

Objective: 11.2 Describe the nature of current liabilities, and account for common current liabilities including provisions.

31) Which statement about warranties is correct?

- A) Warranties sold separately are accounted for under IAS37.
- B) Warranties sold separately are accounted for under IAS18.
- C) Warranties are financial liabilities and accounted for at fair value.
- D) Expected value uses a weighted average of possible outcomes.

Answer: B

Diff: 2

Skill: Concept

Objective: 11.2 Describe the nature of current liabilities, and account for common current liabilities including provisions.

32) Which statement about warranties is correct?

- A) Warranties are provisions.
- B) Warranties included with the product sold are accounted for under IAS18.
- C) Warranties are financial liabilities.
- D) Warranties included with the product sold are accounted for under IAS39.

Answer: A

Diff: 2

Skill: Concept

Objective: 11.2 Describe the nature of current liabilities, and account for common current liabilities including provisions.

33) Sales made in fiscal 2016 for \$50,000,000 include a 5 year warranty coverage. The estimated cost for warranty is expected to be 2% for the first 4 years and 5% for the last year. Determine how much warranty expense will be recorded in fiscal 2016.

- A) 1,000,000
- B) 4,000,000
- C) 5,000,000
- D) 6,500,000

Answer: D

Explanation: D) $(50 \text{ million} \times [(2\% \times 4) + 5\%])$

Diff: 2

Skill: Comp

Objective: 11.2 Describe the nature of current liabilities, and account for common current liabilities including provisions.

34) Which statement about deferred revenue is correct?

- A) Deferred revenue is a financial liability.
- B) Deferred revenue is a non-financial liability.
- C) Deferred revenue is a held for trading financial liability.
- D) Deferred revenue arises when the contract is signed.

Answer: B

Diff: 2

Skill: Concept

Objective: 11.2 Describe the nature of current liabilities, and account for common current liabilities including provisions.

35) Which statement about deferred revenue is correct?

- A) Deferred revenue is always a non-current liability.
- B) Deferred revenue could arise from loyalty programs.
- C) Deferred revenue is measured using expected values.
- D) Deferred revenue arises when the goods are shipped.

Answer: B

Diff: 2

Skill: Concept

Objective: 11.2 Describe the nature of current liabilities, and account for common current liabilities including provisions.

36) AV Airlines sold a ticket on May 1, 2016 for travel on Jun 15, 2016 for \$1,500. The customer paid at time of booking the flight. Provide the necessary journal entries.

Answer:

Booking flight

Dr. Cash	1,500	
Cr. Unearned revenue		1,500

Take flight

Dr. Unearned revenue	1,500	
Cr. Revenue		1,500

Diff: 1

Skill: Comp

Objective: 11.2 Describe the nature of current liabilities, and account for common current liabilities including provisions.

37) A clothing store maintains a loyalty program for its customers. For every purchase, members receive points that do not expire. In fiscal 2016, the store made sales of \$1 million and awarded 50,000 points that have a fair value of \$50,000. The company estimates that approximately 75% of these points will be redeemed by members. Members redeemed 10,000 points in fiscal 2017.

Provide the necessary journal entries for fiscal 2015 and 2016.

Answer:

2016

Dr. Cash	1,000,000	
Cr. Revenue		950,000
Cr. Unearned revenue		50,000

2017

Dr. Unearned revenue	13,333	
Cr. Revenue		13,333

$10,000 \text{ points} \times [\$50,000 / (50,000 \text{ points} \times 75\% \text{ redemption})]$

$= 10,000 \times 1.33$

Diff: 2

Skill: Comp

Objective: 11.2 Describe the nature of current liabilities, and account for common current liabilities including provisions.

38) A company purchased inventory from Europe valued at \$100,000 euros. The spot rate at the transaction date was C\$1.00 = 0.85 Euro. The spot rate on year end date was C\$1.00 = 0.80 Euro. When the company paid the supplier 3 months after year end the spot rate was C\$1.00 = 0.90 Euro.

Provide all necessary journal entries. Round all amounts to nearest dollar.

Answer:

Purchase date

Dr. Inventory	117,647	
Cr. A/P		117,647

$100,000 \text{ Euro} \times (\text{C}\$1.00 / 0.85 \text{ Euro})$

Year end

Dr. Foreign exchange loss	7,353	
Cr. A/P		7,353

$100,000 \text{ Euro} \times (\text{C}\$1.00 / 0.80 \text{ Euro}) = 125,000$

$117,647 - 125,000 = 7,353 \text{ loss}$

Pay supplier

Dr. A/P	125,000	
Cr. Cash		111,111
Cr. Foreign exchange gain		13,889

$100,000 \text{ Euro} \times (\text{C}\$1.00 / 0.90 \text{ Euro}) = 111,111$

$125,000 - 111,111 = 13,889 \text{ gain}$

Diff: 3

Skill: Comp

Objective: 11.2 Describe the nature of current liabilities, and account for common current liabilities including provisions.

39) Select transactions and other information pertaining to the Best Place in the World Inc. (BPW) are detailed below.

Facts:

- a. BPW is domiciled in Vancouver, British Columbia and all purchases and sales are made in BC.
- b. The HST rate in British Columbia is 12%.
- c. The balances in BPW's HST recoverable account and HST payable account as at March 31, 2017, were \$7,000 and \$18,000, respectively.
- d. BPW uses a perpetual inventory system.
- e. Inventory is sold at a 100% mark-up on cost. (Cost of goods sold is 50% of the sales price.)

Select transactions in April 2017:

- 1. BPW purchased inventory on account at a cost of \$17,000 plus HST.
- 2. BPW purchased equipment on account at a cost of \$18,000 plus HST. It paid an additional \$600 plus HST for shipping.
- 3. Cash sales-BPW sold inventory for \$45,000 plus HST.
- 4. Sales on account-BPW sold inventory for \$35,000 plus HST.
- 5. BPW paid the supplier in full for the equipment previously purchased on account.
- 6. At the end of the month, BPW remitted the net amount of HST owing to the Canada Revenue Agency.

Required:

Prepare summary journal entries to record the transactions detailed above.

Answer:

Summary journal entries

1.	Dr. Inventory	17,000	
	Dr. HST recoverable ($\$17,000 \times 12\%$)	2,040	
	Cr. Accounts payable		19,040
2.	Dr. Equipment ($\$18,000 + \600)	18,600	
	Dr. HST recoverable ($\$18,600 \times 12\%$)	2,232	
	Cr. Accounts payable		20,832
3.	Dr. Cash [$\$45,000 \times (1 + 12\%)$]	50,400	
	Cr. Sales		45,000
	Cr. HST payable ($\$45,000 \times 12\%$)		5,400
	Dr. Cost of goods sold ($\$45,000 \times 50\%$)	22,500	
	Cr. Inventory		22,500
4.	Dr. Accounts receivable [$\$35,000 \times (1 + 12\%)$]	39,200	
	Cr. Sales		35,000
	Cr. HST payable ($\$35,000 \times 12\%$)		4,200
	Dr. Cost of goods sold ($\$35,000 \times 50\%$)	17,500	
	Cr. Inventory		17,500
5.	Dr. Accounts payable	20,832	
	Cr. Cash		20,832
6.	Dr. HST payable	27,600	
	Cr. HST recoverable		11,272
	Cr. Cash		16,328

Diff: 1

Skill: Comp

Objective: 11.2 Describe the nature of current liabilities, and account for common current liabilities including provisions.

40) Deck Contractors Inc. (DC) enters into a contract to construct six decks adjacent to a commercial building. The purchaser has agreed to pay \$8,500 for each deck (total \$51,000). The terms of the contract call for a 40% deposit (\$3,400 per deck) at time of contract signing and payment of the balance (\$5,100 per deck) as each deck is completed.

The contract is signed on October 1, 2017. Two decks are completed in 2017 and the balance in 2018. DC has a December 31 year-end. The cost to DC of constructing each deck is \$3,400, which it pays in cash.

Required:

- a. Prepare summary journal entries for 2017 and 2018.
- b. What is the balance in the deferred revenue account as at December 31, 2017?

Answer:

a. Summary journal entries

2017	Dr. Cash (6 × \$3,400)	20,400	
	Cr. Deferred revenue		20,400
2017	Dr. Cash (2 × \$5,100)	10,200	
	Dr. Deferred revenue (2 × \$3,400)	6,800	
	Cr. Revenue (2 × \$8,500)		17,000
	Dr. Cost of goods sold (2 × \$3,400)	6,800	
	Cr. Cash		6,800
2018	Dr. Cash (4 × \$5,100)	20,400	
	Dr. Deferred revenue (4 × \$3,400)	13,600	
	Cr. Revenue (4 × \$8,500)		34,000
	Dr. Cost of goods sold (4 × \$3,400)	13,600	
	Cr. Cash		13,600

- b. The balance in the deferred revenue account as at December 31, 2017 was \$13,600 (\$20,400 - \$6,800)

Diff: 1

Skill: Comp

Objective: 11.2 Describe the nature of current liabilities, and account for common current liabilities including provisions.

41) In 2017, Johnson's Cycles Inc. sold 5,000 mountain bikes. For the first time, Johnson offered an in-store, no-charge, two-year warranty on each bike sold. Company management estimates that the average cost of providing the warranty is \$8 per unit in the first year of coverage and \$11 per unit in the second year.

Johnson's warranty-related expenditures totaled \$36,500 for labor costs during 2017.

Required:

- a. Prepare the summary journal entry to recognize Johnson's warranty expense in 2017.
- b. Prepare the summary journal entry to recognize the warranty service provided in 2017.
- c. Determine the total provision for warranty obligations that will be reported on the company's balance sheet at year-end. Assuming that all sales transactions and warranty service took place on the last day of the year, how much of the warranty obligation will be classified as a current liability? As a non-current liability?

Answer:

a.

Dr. Warranty expense	95,000	
Cr. Provision for warranty obligations		95,000
5000 × (\$8 + \$11)		

b.

Dr. Provision for warranty obligations	36,500	
Cr. Wage expense		36,500

- c. The total provision for warranty obligations that will be reported at year-end is \$58,500 (\$95,000 - \$36,500). Of this amount, \$3,500 will be reported as a current obligation [(5000 × \$8) - \$6,000 = \$6,500] and the \$55,000 balance as a non-current liability (5000 × \$11= \$17,500)

Diff: 1

Skill: Comp

Objective: 11.2 Describe the nature of current liabilities, and account for common current liabilities including provisions.

42) On May 1, 2016, British Columbia Brew Supplies Inc. borrowed US\$ 180,000 from its bank. British Columbia's year-end is December 31, 2016. Exchange rates were as follows:

May 1, 2016	US\$1.00 = C\$1.05
Dec 31, 2016	US\$1.00 = C\$1.07
Average rate May 1-Dec 31, 2016	US\$1.00 = C\$1.06

Required:

Prepare the required journal entries to record receipt of the loan proceeds and for any adjustments required at year-end.

Answer:

May 1,	Dr. Cash (US\$180,000 × \$1.05)	189,000	
2016	Cr. Bank loan		189,000
Dec. 31,	Dr. Foreign exchange loss (US\$180,000 × (\$1.07 - \$1.05))	3,600	
2016	Cr. Bank loan		3,600

Diff: 1

Skill: Comp

Objective: 11.2 Describe the nature of current liabilities, and account for common current liabilities including provisions.

43) On January 1, 2017 BCL Transmission Services Co. issued a \$40,000, non-interest bearing note, due on January 1, 2018, in exchange for a custom-built computer system. The fair value of the computer system is not easily determinable. The market rate of interest for similar transactions is 4%. BCL's year-end is December 31.

Required:

- Prepare the journal entry to record the issuance of the note payable.
- Prepare the journal entry to record the accrual of interest at December 31, 2017, assuming that BCL prepares adjusting entries only at year-end.
- Prepare the journal entry to record the retirement of the note payable on January 1, 2018.

Answer:

a.	Dr. Computer system	38,462	
	Cr. Note payable (\$40,000 / 1.04)		38,462
	Using a BAII PLUS financial calculator		
	1N, 4 I/Y, 40000 FV, CPT PV PV		
b.	Dr. Interest expense	1,538	
	Cr. Note payable		1,538
	\$38,462 × 4%		
c.	Dr. Note payable	40,000	
	Cr. Cash		40,000

No entry for interest is required as it had been accrued on December 31, 2017.

Diff: 1

Skill: Comp

Objective: 11.2 Describe the nature of current liabilities, and account for common current liabilities including provisions.

44) St. John Laurulry (SJL) recently hired Huck as its payable clerk, a position that has been vacant for two months. While the other accounting staff have taken care of the "must do's," there are a number of transactions that have not yet been recorded.

- Nov. 15, 2017—SJL purchases \$8,000 supplies inventory on account. The terms offered are 2/10, net 30.
- Nov. 22, 2017—SJL purchases 10 washing machines. SJL issues a \$3,000 non-interest bearing note payable due on 01/15/18.
- Nov. 28, 2017—SJL borrows \$131,400 from the bank. SJL signs a demand note for this amount and authorizes the bank to take the interest payments from its bank account. Interest is payable monthly at 10% per annum.
- Dec. 18, 2017—SJL purchases \$1,000 supplies inventory on account. The terms offered are 2/10, net 30.
- Dec. 21, 2017—SJL purchases 15 dryers. SJL issues a \$25,000 non-interest bearing note payable due on Dec. 21, 2018.
- Dec. 22, 2017—Huck pays the Nov. 15, 2017 and Dec. 18, 2017 invoices.
- Dec. 31, 2017—Huck processes the payroll for the month. The gross payroll is \$80,000; \$2,700 is withheld for the employees' Canada Pension Plan and Employment Insurance premiums.

Other Info

- SJL uses the net method to record accounts payable.
- SJL's year-end is Dec. 31 and interim statements are normally prepared on a monthly basis.
- Due to the vacancy in the accounting department, SJL's latest interim statements are for the period ended Oct. 31, 2017. The necessary accruals were made at that time.
- The market rate of interest for SJL's short-term borrowings is 10%.

Required:

- a. Prepare journal entries to record the documented events and the necessary accruals for the months of November and December. Compute interest accruals based on the number of days, rather than months.
- b. Contrast the gross and net methods of accounting for trade payables.

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Answer:

a.

Nov. 15, 2017	Dr. Supplies inventory	7,840	
	Cr. Trade payables		7,840
	[\$8,000 × (100% - 2%)]		
Nov. 22, 2017	Dr. Equipment—washing machines	3,000	
	Cr. Notes payable		3,000
	Recorded at face value as it is a short-term note and the interest component is immaterial		
Nov. 28, 2017	Dr. Cash	131,400	
	Cr. Notes payable		131,400
Nov. 30, 2017	Dr. Interest expense (bank loan)	108	
	Cr. Cash (\$131,400 × 10% × 3/365)		108
Dec. 18, 2017	Dr. Supplies inventory	980	
	Cr. Trade payables (\$1,000 × (100% - 2%))		980
Dec. 21, 2017	Dr. Equipment—dryers	22,727	
	Cr. Notes payable (\$25,000 / 1.10)		22,727
	Using a BAII PLUS financial calculator 1N, 4 I/Y, 2500 FV, CPT PV		

10% is an appropriate discount rate to use as the question identifies this as the market rate of interest for NVL's short-term borrowings

Dec. 22, 2017	Dr. Trade payables	8820	
	Dr. Purchase discounts lost	160	
	Cr. Cash		8,980
Dec. 31, 2017	Dr. Payroll expense	80,000	
	Cr. Cash		77,300
	Cr. Employee remittances payable		2,700
Dec. 31, 2017	Dr. Interest expense (note payable)	68	
	Cr. Note payable [\$22,727 × 10% × 11/365]		68
Dec. 31, 2017	Dr. Interest expense (bank loan)	1,116	
	Cr. Cash		1,116
	[\$131,400 × 10% × 31/365]		

b. When the gross method is used, the payable is recorded at the invoiced amount, as is the asset acquired. If the discount is taken, the book value of the asset acquired is reduced by an equivalent amount. If the discount is not taken, an adjustment is not required.

When the net method is used, the payable is recorded at the invoiced amount less the discount, as is the asset acquired. If the discount is taken, an adjustment is not required. If the discount is not taken, an income statement account "purchase discounts lost" is debited for the amount of the discount forgone.

From a theoretical perspective, the net method should be used as forgone discounts are a financing cost. From a practical perspective, the gross method is widely used as it is simpler to use and as the forgone discounts are usually immaterial.

Diff: 2

Skill: Comp

Objective: 11.2 Describe the nature of current liabilities, and account for common current liabilities including provisions.

45) RJ Magazines sells two-year magazine subscriptions for \$108 cash each. The cost of producing and delivering each monthly magazine is \$2.75 paid in cash at the time of delivery. RJ's sales activity for the year follows:

Sales activity

- On January 1, 2017, RJ sells 22,000 subscriptions.
- On April 1, 2017, RJ sells 5,000 subscriptions.
- On November 1, 2017, RJ sells 12,000 subscriptions

RJ delivers the magazines at the end of the month and the year-end is December 31.

Required:

- a. Prepare journal entries to record the subscription sales during the year.
- b. Prepare summary journal entries to record the revenue earned during the year and the related expense.

Answer:

a.

Jan. 1	Dr. Cash	2,376,000	
	Cr. Deferred revenue		2,376,000
	22,000 × \$108		
Apr. 1	Dr. Cash	540,000	
	Cr. Deferred revenue		540,000
	5,000 × \$108		
Nov. 1	Dr. Cash	1,296,000	
	Cr. Deferred revenue		1,296,000
	12,000 × \$108		

b.

Dec. 31	Dr. Deferred revenue	1,498,500		
	Cr. Revenue		1,498,500	
Dec. 31	Dr. Magazine expense	915,750		
	Cr. Cash		915,750	
\$108/24 = \$4.50 in revenue per magazine sold				
Sales date	Number sold—A	Months delivered—B	Revenue—A × B × \$4.50	Expense—A × B × \$2.75
Jan. 1	22,000	12	\$1,188,000	\$726,000
Apr. 1	5,000	9	202,500	123,750
Nov. 1	12,000	2	108,000	66,000
Revenue and expense to be recognized			\$1,498,500	\$915,750

Diff: 2

Skill: Comp

Objective: 11.2 Describe the nature of current liabilities, and account for common current liabilities including provisions.

46) GOT Jetski Corp. has sold motorized watercraft for a number of years. GOT includes a three-year warranty on each watercraft they sell. Management estimates that the cost of providing the warranty coverage is 2% of sales in the first year and 3% of sales in each of years two and three. Other facts follow:

- GGT reported a \$270,000 provision for warranty payable on its December 31, 2017 balance sheet.
- GGT's sales for 2018 totalled \$6,000,000 spread evenly through the year.
- The cost to GGT of meeting their warranty claims in 2018 was \$480,000; \$300,000 for parts and \$180,000 for labour.
- GGT's sales for 2019 totalled \$6,200,000 spread evenly through the year.
- The cost to GGT of meeting their warranty claims in 2019 was \$468,000; \$280,800 for parts and \$187,200 for labour. Based on recent claims history, GGT revises their 2019 warranty provision to 9% of sales.

Required:

- a. Prepare summary journal entries to record warranty expense and warranty claims in 2018 and 2019.
- b. Determine the provision for warranty payable that GGT will report as a liability on December 31, 2019.

Answer:

To recognize the provision in 2018

a. Dr. Warranty expense	480,000	
Cr. Provision for warranty payable		480,000
[\$6,000,000 × (2% + 3% + 3%)]		

To recognize partial satisfaction of the warranty obligation in 2018

Dr. Provision for warranty payable	480,000	
Cr. Parts inventory		300,000
Cr. Wage expense		180,000

To recognize the provision in 2019

Dr. Warranty expense	558,000	
Cr. Provision for warranty payable		558,000
(\$6,200,000 × 9%)		

To recognize partial satisfaction of the warranty obligation in 2019

Dr. Provision for warranty payable	468,000	
Cr. Parts inventory		280,800
Cr. Wage expense		187,200

b. The balance in the warranty payable account as at December 31, 2019 was \$360,000 as set out in the T-account that follows:

Provision for Warranty Payable

		270,000 Balance Dec 31 2017
		480,000 Provision 2018
Claims 2018	480,000	
Claims 2019	468,000	558,000 Provision 2019
		360,000 Balance Dec 31 2019

Diff: 2

Skill: Comp

Objective: 11.2 Describe the nature of current liabilities, and account for common current liabilities including provisions.

47) LMZ Computer Systems Inc. maintains office equipment under contract. The contracts are for labour only; customers must reimburse LMZ for parts. LMZ's rate schedule follows:

	One year	Two years	Three years
Photocopies	\$220	400	620
Fax machine	\$175	340	440

LMZ's 2018 sales of maintenance agreements is set out below:

	One year	Two years	Three years
Photocopies	20	12	30
Fax machine	24	20	30

Required:

Assuming that sales occurred evenly through the year:

- What amount of revenue will LMZ recognize for the year ended December 31, 2018?
- What amount of deferred revenue will LMZ report as a current liability on December 31, 2018?
- What amount of deferred revenue will LMZ report as a non-current liability on December 31, 2018?

Answer:

- Sales occurred evenly during the year, therefore in 2018 LMZ earned, on average, six months of revenue on the maintenance contracts. As per the chart below, LMZ earned revenues of \$12,500.

a.	One year	Two year	Three year	Revenue earned
Photocopiers	\$220	\$400	\$620	
# of contracts sold	<u>20</u>	<u>12</u>	<u>30</u>	
\$value of contracts sold	\$4,400	\$4,800	18,600	
Revenue earned (%)*	<u>50%</u>	<u>25%</u>	<u>16 2/3%</u>	
Revenue earned (\$)	\$2,200	\$1,200	\$3,100	\$6,500
Fax machines	\$175	\$340	\$440	
# of contracts sold	<u>24</u>	<u>20</u>	<u>30</u>	
\$value of contracts sold	\$4,200	\$6,800	\$13,200	
Revenue earned (%)	<u>50%</u>	<u>25%</u>	<u>16 2/3%</u>	
Revenue earned (\$)	\$2,100	\$1,700	\$2,200	\$6,000
				<u>\$12,500</u>

* 6 months earned / 12 month contract = 50%; 6 month / 24 month contract = 25%; 6 month / 36 month contract = 16 2/3%

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b. and c.

b. and c.	Total deferred	Current	Non-current
Photocopiers			
One year	\$2,200	\$2,200	\$0
Two year*	\$3,600	\$2,400	\$1,200
Three year**	\$15,500	\$6,200	\$9,300
Total	\$21,300	\$10,800	\$10,500
Fax machines			
One year	\$2,100	\$2,100	\$0
Two year***	\$5,100	\$3,400	\$1,700
Three year****	\$11,000	\$4,400	\$6,600
Total	\$18,200	\$9,900	\$8,300
Total		<u>\$20,700</u>	<u>\$18,800</u>

* The value of the two-year photocopier contracts sold was \$4,800. One year of the two year agreement is a current liability - $\$4,800 / 2 = \$2,400$

** The value of the three-year photocopier contracts sold was \$18,600. One year of the three year agreement is a current liability - $\$18,600 / 3 = \$6,200$

*** The value of the two-year fax machine contracts sold was \$6800. One year of the two year agreement is a current liability - $\$6,800 / 2 = \$3,400$

**** The value of the three-year fax machine contracts sold was \$13,200. One year of the three year agreement is a current liability - $\$13,200 / 3 = \$4,400$

Diff: 3

Skill: Comp

Objective: 11.2 Describe the nature of current liabilities, and account for common current liabilities including provisions.

48) It is early in February 2017 and you are conducting the audit of Blast Off Airline's 2016 financial statements. Through discussion with Blast Off's Chief Financial Officer you learn of matters that have not yet been incorporated into the 2016 financial statements:

During 2016, Blast Off began a customer loyalty program. For each aeronautical mile that a passenger travels on a paid flight, the passenger accrues one flight mile. Passengers can redeem accrued flight miles for free air travel. Earned miles do not expire. Blast Off's analysis of its competitors' programs suggests an average redemption rate of 55%. In 2016, Blast Off awarded 50,000,000 flight miles, 1,375,000 of which were redeemed. Management estimates the fair value of the flight miles is \$540,000.

Required:

Prepare the journal entries to record the required adjustments for the above event.

Answer:

To allocate a portion of the ticket sales proceeds to the award program

Dr. Flight revenue	540,000	
Cr. Unearned revenue (award miles)		540,000

As the award portion of the flights has not previously been allowed for, an entry is required to reverse a portion of the ticket sales revenue from flight revenue to award revenue

To recognize award point revenue in 2016

Dr. Unearned revenue (award miles)	27,000	
Cr. Award revenue		27,000

(50,000,000 × 55% = 27,500,000) miles expected to be redeemed. (1,375,000/27,500,000 × \$540,000 = \$27,000)

Diff: 2

Skill: Comp

Objective: 11.2 Describe the nature of current liabilities, and account for common current liabilities including provisions.

11.3 Learning Objective 3

1) Which statement about contingencies is correct?

- A) It involves only potential economic outflows of resources.
- B) It is a possible condition that depends upon the outcome of a future event.
- C) It involves uncertainty about either the timing or amount of payment.
- D) It is an existing condition that depends upon the outcome of a future event.

Answer: D

Diff: 2

Skill: Concept

Objective: 11.3 Describe the nature of current assets, and liabilities and account for these items.

2) Which statement about contingent assets is correct?

- A) It involves only potential economic outflows of resources.
- B) It is a possible asset that depends upon the outcome of a future event.
- C) It involves uncertainty about either the timing or amount of payment.
- D) It is a condition that depends upon the outcome of a forecasted event.

Answer: B

Diff: 2

Skill: Concept

Objective: 11.3 Describe the nature of current assets, and liabilities and account for these items.

3) Which statement about contingent liabilities is correct?

- A) It is a possible obligation that arises from past transactions and events.
- B) It is an obligation that arises from past transactions and events.
- C) It involves uncertainty about either the timing or amount of payment.
- D) It is a condition that depends upon the outcome of an anticipated event.

Answer: A

Diff: 2

Skill: Concept

Objective: 11.3 Describe the nature of current assets, and liabilities and account for these items.

4) Which statement about contingent liabilities is correct?

- A) It is a present obligation that will probably result in the economic outflow of resources.
- B) It involves uncertainty about either the timing of payment or the amount of payment.
- C) It is an obligation that arises from past transactions and events and can be reliably measured.
- D) It is a present obligation that arises from past events but it cannot be reliably measured.

Answer: D

Diff: 2

Skill: Concept

Objective: 11.3 Describe the nature of current assets, and liabilities and account for these items.

5) Which statement about contingencies is correct?

- A) If the future outcome is possible and reliably measurable, a provision is recorded.
- B) If the future outcome is probable and reliably measurable, a provision is recorded.
- C) If the future outcome is probable, a provision is recorded even if it is not reliably measurable.
- D) If the future outcome is possible, a provision is recorded even if it is not reliably measurable.

Answer: B

Diff: 2

Skill: Concept

Objective: 11.3 Describe the nature of current assets, and liabilities and account for these items.

6) Explain what contingent assets and liabilities are and how these items are accounted for financial reporting purposes.

Answer: A contingent liability is:

- a possible obligation whose existence can be confirmed only by future events that are not wholly controlled by the entity; or
- it is possible but not probable that the obligation will have to be paid; or
- the obligation cannot be measured with sufficient reliability.

Contingencies that are probable are reported as provisions. Contingencies that are possible are disclosed in the notes to the financial statements.

A contingent asset is a possible asset whose existence can be confirmed only by future events that are not wholly controlled by the entity. Contingent assets are not recognized in the financial statements.

Diff: 1

Skill: Concept

Objective: 11.3 Describe the nature of current assets, and liabilities and account for these items.

7) Explain the difference between "probable," "possible," and "remote" under IFRS.

Answer:

Probable: The probability of occurrence is greater than 50%.

Remote: is not numerically defined in IAS 37, but rather uses the common meaning of the word. Possible:

A probability of 50% or less., but greater than remote.

This is a matter of professional judgment, with each case being decided on its own merits. The upper bound of remote would normally fall between 5% and 10%.

Diff: 1

Skill: Concept

Objective: 11.3 Describe the nature of current assets, and liabilities and account for these items.

8) Which statement about contingencies is correct?

- A) If the future outcome is remote but reliably measurable, a provision is recorded.
- B) If the future outcome is remote, but not reliably measurable, disclosure is required.
- C) If the future outcome is remote, but not reliably measurable, no action is required.
- D) If the future outcome is remote, but reliably measurable, disclosure is required.

Answer: C

Diff: 2

Skill: Concept

Objective: 11.3 Describe the nature of current assets, and liabilities and account for these items.

9) Which statement about contingencies is correct?

- A) If the future outcome is possible and reliably measurable, a provision is recorded.
- B) If the future outcome is possible, but reliably measurable, no action is required.
- C) If the future outcome is possible, but not reliably measurable, no action is required.
- D) If the future outcome is possible, but reliably measurable, disclosure is required.

Answer: D

Diff: 2

Skill: Concept

Objective: 11.3 Describe the nature of current assets, and liabilities and account for these items.

10) Which statement about contingencies is correct?

- A) If the future outcome is probable and reliably measurable, a provision is recorded.
- B) If the future outcome is probable, disclosure is required if it is reliably measurable.
- C) If the future outcome is probable, but not reliably measurable, no action is required.
- D) If the future outcome is probable, a provision is required, even if it is not reliably measurable,

Answer: A

Diff: 2

Skill: Concept

Objective: 11.3 Describe the nature of current assets, and liabilities and account for these items.

11) Which statement is correct about provisions, contingent assets and contingent liabilities?

- A) Provisions are recorded in the financial statements whereas contingent assets are not recorded.
- B) Provisions are recorded in the financial statements whereas contingent liabilities are not recorded.
- C) Probable contingent liabilities are recorded at management's best estimates.
- D) Probable contingent assets are recorded at management's best estimates.

Answer: A

Diff: 3

Skill: Concept

Objective: 11.3 Describe the nature of current assets, and liabilities and account for these items.

12) Which statement is correct about provisions, contingent assets and contingent liabilities?

- A) The same probability threshold is used to record contingent liabilities and provisions.
- B) The same probability threshold is used to record contingent assets and contingent liabilities.
- C) Possible contingent liabilities are recorded.
- D) Virtually certain contingent assets are recorded.

Answer: D

Diff: 3

Skill: Concept

Objective: 11.3 Describe the nature of current assets, and liabilities and account for these items.

13) It is early in February 2017 and you are conducting the audit of Blast Off Airline's 2016 financial statements. Through discussion with Blast Off's Chief Financial Officer you learn of matters that have not yet been incorporated into the 2016 financial statements:

In July 2016, 127 passengers on board Blast Off Airlines Flight 007 were seriously injured when the plane missed the runway on final approach. In January 2017, the injured passengers launched a class action lawsuit against Blast Off seeking damages of \$15 million. Blast Off's internal investigation of the incident determined that the pilot was intoxicated during the flight. The company's solicitors suggest that if the matter goes to court, Blast Off will be found liable and ordered to pay the \$15 million.

In an attempt to reduce its loss, Blast Off's solicitors made a settlement offer of \$10 million to the plaintiffs. The litigants' attorney has not provided a formal response but has indicated that the offer is being seriously considered. Blast Off's lawyers estimate that there is a 90% probability the plaintiffs will accept the offer.

Required:

Prepare the journal entries to record the required adjustments for the above event.

Answer:

To provide for the expected liability settlement

Dr. Lawsuit settlement expense	10,500,000	
Cr. Provision for liability settlement costs		10,500,000
[($\$10,000,000 \times 90\%$) + ($\$15,000,000 \times 10\%$)]		

Diff: 2

Skill: Comp

Objective: 11.3 Describe the nature of current assets, and liabilities and account for these items.

14) Consider the following independent situations. The underlined entity is the reporting entity.

1. The Supreme Court of Canada ordered a supplier to pay Towna Haring Inc. \$500,000 for breach of contract.
2. Iwas Pharmaceuticals Inc. sued Game Day Agencies Ltd. for \$8 million alleging patent infringement. While there may be some substance to Iwas's assertion, Game Day's legal counsel estimates that Iwas's likelihood of success is about 30%.
3. Environment Canada sued Foil Fan Isotopes Ltd. for \$18 million seeking to recover the costs of cleaning up Foil Fan's accidental discharge of radioactive materials. Foil Fan acknowledges liability but is disputing the amount, claiming that the actual costs are in the range of \$9 million to \$12 million. Foil Fan's \$18 million environmental insurance policy includes a \$6 million deductible clause.

Required:

- a. For each of the situations, indicate whether the appropriate accounting treatment is to:
 - A. Recognize an asset or liability.
 - B. Disclose the details of the contingency in the notes to the financial statements.
 - C. Neither provide for the item nor disclose the circumstances in the notes to the financial statements.
- b. For each situation that requires the recognition of an asset or liability, record the journal entry.

Answer:

1. (A)

Answer = A. Recognize an asset or liability.

The asset is provided for as the outcome is virtually certain. Supreme Court decisions cannot be appealed. The supporting journal entry is:

Dr. Other receivables (lawsuit)	500,000	
Cr. Lawsuit award		500,000

2. (B) The outcome is possible but not probable, so note disclosure is required.

Answer = B. Disclose the details of the contingency in the notes to the financial statements.

No Entry

3. (A)

Answer = A. Recognize an asset or liability.

A \$6,000,000 liability is provided for as the loss is probable and can be reliably measured. While the final settlement may be as low as \$9 million or as high as \$11 million, company is responsible only for the \$6,000,000 deductible.

Dr. Environmental cleanup expense	6,000,000	
Cr. Provision for environmental cleanup costs		6,000,000

Diff: 2

Skill: Comp

Objective: 11.3 Describe the nature of current assets, and liabilities and account for these items.

15) Consider the following independent situations. The underlined entity is the reporting entity.

1. Call Cattle Inc. sued **Nutrient Feed Ltd.** for \$10 million alleging breach of contract. Nutrient's legal counsel estimates that Call's likelihood of success is about 80%. Based on its experience with cases of this nature, the law firm estimates that, if successful, the litigants will be awarded \$8,800,000 to \$9,000,000, with all payouts in this range being equally likely.
2. Deana Finnamore broke her leg when she tripped on an uneven floor surface in **Groton Co.'s** office. On the advice of legal counsel, Groton has offered Finnamore \$140,000 to settle her \$275,000 lawsuit. It is unknown whether Finnamore will accept the settlement offer. **Groton's** legal counsel estimates that Finnamore has a 90% probability of success, and that if successful, she will be awarded \$230,000.
3. The courts ordered a competitor to pay \$1,000,000 to **Ferbert and Finn Corp.** for patent infringement. The competitor's legal counsel indicated that the company will probably appeal the amount of the award.

Required:

- a. For each of the situations, indicate whether the appropriate accounting treatment is to:
 - A. Recognize an asset or liability.
 - B. Disclose the details of the contingency in the notes to the financial statements.
 - C. Neither provide for the item nor disclose the circumstances in the notes to the financial statements.
- b. For each situation that requires the recognition of an asset or liability, record the journal entry.

Answer:

1. (A)

Answer = A. Recognize an asset or liability.

The loss is probable and has to be provided for. Expected value techniques may be used to determine the amount of the obligation based on legal counsel's best estimate of the amount required to settle the obligation. The midpoint of the range has been used as a starting point as if the plaintiff is successful all payouts in the stipulated range are equally likely.

Dr. Contract settlement expense	7,120,000	
Cr. Provision for contract settlement costs		7,120,000
[[(\$8,800,000 + \$9,000,000) / 2] × 80%] + (\$0 × 20%)		

2. (A)

Answer = A. Recognize an asset or liability.

The loss is probable and so the company must make a provision. Expected value techniques should be used to determine the amount of the obligation based on legal counsel's best estimate of the amount required to settle the obligation. If the company subsequently accepts the offer, this is a change in estimate that will be dealt with prospectively.

Dr. Lawsuit settlement expense	207,000	
Cr. Provision for liability settlement costs		207,000
(\$230,000 × 90%) + (\$0 × 10%)		

3. (C or possibly B)

Answer = C. Neither provide for the item nor disclose the circumstances in the notes to the financial statements.

OR

Possibly B. Disclose the details of the contingency in the notes to the financial statements.

The outcome is certainly possible but as the appeal process has not yet been exhausted it is not virtually certain. Whether the outcome is probable (requiring disclosure) or possible (neither provided for nor disclosed) is a matter of professional judgment.

Diff: 2

Skill: Comp

Objective: 11.3 Describe the nature of current assets, and liabilities and account for these items.

11.4 Learning Objective 4

1) Which statement is correct?

- A) Contingencies arise from future events.
- B) Financial guarantees arise from contracts previously entered into.
- C) Current liabilities arise from future events.
- D) The amount to be paid for financial guarantees is known or reasonably estimable.

Answer: B

Diff: 2

Skill: Concept

Objective: 11.4 Describe the nature of commitments and guarantees and apply accrual accounting to them.

2) Indemnities and letters of credit are examples of?

- A) Commitments.
- B) Provisions.
- C) Contingencies.
- D) Guarantees.

Answer: D

Diff: 2

Skill: Concept

Objective: 11.4 Describe the nature of commitments and guarantees and apply accrual accounting to them.

3) Gladstone Distributors Inc. entered into a non-cancellable contract to buy 40,000 litres of linseed oil for \$6 per litre for resale purposes. Gladstone intends to resell the oil to retail paint outlets for \$10 per litre. The contract was entered into on October 31, 2016 for delivery on January 15, 2017. Gladstone's year-end is December 31. On December 12, 2016, Gladstone's supplier reduces the price to \$5.10 per litre due to adverse market conditions.

Required:

- a. Outline the required accounting treatment assuming that Gladstone expects it can sell the oil for \$6.45 per litre.
- b. Outline the required accounting treatment assuming that Gladstone expects it can sell the oil for \$5.55 per litre.

Answer:

Economic analysis		
	Situation a	Situation b
Expected economic benefit	$40,000 \times \$6.45 = \$258,000$	$40,000 \times \$5.55 = \$222,000$
Unavoidable costs	$40,000 \times \$6.00 = \$240,000$	$40,000 \times \$6.00 = \$240,000$
Profit (Loss)	<u>\$ 18,000</u>	<u>\$ (18,000)</u>
Result	Non-onerous contract	Onerous contract for which the expected loss must be provided

- a. While the company has contracted to pay more for the oil than the current market price, it remains that the expected economic benefit exceeds the unavoidable costs. The contract is thus non-onerous and does not need to be provided for.
- b. The expected economic benefit is less than the unavoidable costs and must be provided for.

Dr. Loss on onerous contract	18,000	
Cr. Provision for loss on onerous contract		18,000

Diff: 2

Skill: Comp

Objective: 11.4 Describe the nature of commitments and guarantees and apply accrual accounting to them.

4) Explain how commitments and guarantees are accounted for under accrual accounting.

Answer: Contractual commitments pertaining to the acquisition of property, plant, and equipment must be disclosed.

Enterprises shall record provisions for onerous contracts.

Enterprises shall record provisions for financial guarantee contracts and disclose such guarantees.

Diff: 1

Skill: Concept

Objective: 11.4 Describe the nature of commitments and guarantees and apply accrual accounting to them.

5) Explain the meaning of the following terms: "financial guarantee" contract and "onerous" contract

Answer:

financial guarantee contract: A contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due.

onerous contract: A contract in which the unavoidable costs of fulfilling it exceed the benefits expected to be received.

Diff: 1

Skill: Concept

Objective: 11.4 Describe the nature of commitments and guarantees and apply accrual accounting to them.

11.5 Comprehensive Questions

1) For each independent situation: **

1. A former employee of Melvin Minimarket Inc. sued the company for \$900,000, alleging that the company owner sexually harassed her. Melvin's lawyers suggest that the lawsuit has a 30-40% probability of success and that, if successful, the plaintiff will be awarded between \$400,000 and \$500,000.
2. Leduc Pyrotechnics Ltd. received a \$15,000 fee to guarantee the \$800,000 bank indebtedness of Kenora Fireworks Inc. The fair value of the guarantee is initially estimated to be \$15,000.
3. Montgomery Syringes Co. sued a competitor for \$800,000, alleging corporate espionage. Montgomery's legal counsel believes that the company will be successful and will be awarded somewhere in the range of \$650,000 to \$800,000.

Required:

Describe how the event should be dealt with in the financial statements and explain why. Prepare all required journal entries.

Answer:

1. This contingent liability does not need to be provided for as it is only possible (20%-30%), not probable (>50%). Note disclosure of the underlying circumstances is required.
2. Company must record the amount received as a liability and also disclose its \$800,000 maximum exposure to the underlying credit risk.

Dr. Cash	15,000	
Cr. Liability for financial guarantee		15,000

3. This contingent asset cannot be recognized as realization is not virtually certain. As realization is probable, note disclosure of the underlying circumstances is appropriate.

Diff: 2

Skill: Comp

Objective: 11.2 Describe the nature of current liabilities and account for common current liabilities including provisions; 11.3 Describe the nature of contingent assets and liabilities and account for these items; 11.4 Describe the nature of commitments and guarantees and apply accrual accounting to them.

2) For each independent situation:

1. A customer sued Vernon Tractor Corp. for \$300,000 for breach of contract. Vernon's solicitors advise that they will almost certainly be found liable. Based on previous results, counsel estimates that there is a 70% probability that the courts will award the \$300,000 being sought; a 20% probability that \$230,000 will be conferred; and a 10% probability that the judgment will be \$140,000.

2. Pickering Conveyor and Clutch Ltd. are in the midst of preparing their financial statements for the year ended December 31, 2018. Pickering has been in ongoing discussions with its bankers about renewing its \$2,500,000 loan maturing on June 30, 2019. While nothing had been finalized by year-end, the bank did agree to extend the maturity by five years on January 15, 2019.

Required:

Describe how the event should be dealt with in the financial statements and explain why. Prepare all required journal entries.

Answer:

1. The loss is probable and has to be provided for. Expected value techniques may be used to determine the amount of the obligation.

Dr. Loss on lawsuit (breach of contract)	270,000	
Cr. Provision for lawsuit settlement costs		270,000
[($\$300,000 \times 70\%$) + ($\$230,000 \times 20\%$) + ($\$140,000 \times 10\%$)]		

2. A journal entry is not required. Rather, the \$2,500,000 must be disclosed as a current liability in the 2018 financial statements as renewal was not effected before year-end. The fact that the bank agreed to renew the loan after year-end, but before the statements were authorized for issue, is disclosed as a non-adjusting event in the notes to the financial statements.

Diff: 2

Skill: Comp

Objective: 11.2 Describe the nature of current liabilities and account for common current liabilities including provisions; 11.3 Describe the nature of contingent assets and liabilities and account for these items; 11.4 Describe the nature of commitments and guarantees and apply accrual accounting to them.

3) For each independent situation:

1. **Moosehead Pool and Skeet Com.'s** debt to equity ratio is 1.6: 1 based on its draft financial statements for the year ended December 31, 2016. This leverage ratio exceeds the 1.5:1 maximum stipulated in Moosehead's loan agreement pertaining to a \$5,000,000 loan maturing on March 15, 2019. The loan agreement stipulates that the loan becomes payable on demand upon breach of any of the loan covenants. Moosehead's creditors agreed on December 15, 2016 to waive their right to demand payment until December 31, 2017 for reason only that the firm's leverage ratio exceeds the stipulated maximum.

2. **Guelph Piano Storage Inc.** issued a \$30,000, 30-day, non-interest bearing note to Roland's Crating for storage bins. The market rate of interest for similar transactions is 2.5%.

3. On November 30, 2014, **Port Meadow Fertilizer Ltd.** entered into a non-cancellable agreement to buy 10 tonnes of phosphorus for \$1,600 per tonne for delivery on February 28, 2015. Phosphorus is a key component of the custom fertilizer that Port Meadow produces. The market price of phosphorus is extremely volatile, as evident by the \$1,175 per tonne that it could be acquired for on December 31, 2014. Notwithstanding the premium price paid for the phosphorus, the company expects that fertilizer sales will remain profitable. Port Meadow's year-end is December 31, 2014.

Required:

For each of the situations described above, prepare the required journal entry for the **underlined entity**. If a journal entry is not required, explain why.

Answer:

1. A journal entry is not required as the outstanding amount of the liability has not changed. From a reporting perspective, the loan will be reported as a non-current obligation as the lender agreed to a 12-month grace period before year-end.

2. IFRS allows for short-term, zero-interest-rate notes to be measured at the original invoice amount if the effect of discounting is immaterial. This is the case here as the note is due in 30 days and the imputed interest amount is immaterial.

Dr. Storage bins	30,000	
Cr. Notes payable		30,000

3. While Port Meadow has contracted to pay more for the phosphorus than the year-end market price, it remains that the expected economic benefit exceeds the unavoidable costs. The contract is thus non-onerous and does not need to be provided for.

Diff: 2

Skill: Comp

Objective: 11.2 Describe the nature of current liabilities and account for common current liabilities including provisions; 11.3 Describe the nature of contingent assets and liabilities and account for these items; 11.4 Describe the nature of commitments and guarantees and apply accrual accounting to them.

4) For each independent situation:

1. **Langford Airport Parking Ltd.** awards customers 250 reward miles per stay, in a well-known airline mileage program. Langford pays the airline \$0.06 for each mile. Langford, which is not an agent for the airline, estimates that the fair value of the miles is the same as the price paid-\$0.06. Parking revenues on May 24, 2017 were \$52,000. Langford awarded 40,000 airline points to its customers.

2. On October 15, 2017, **Hamilton Windows and Sash** properly recorded the issue of a \$12,000, 7% note due April 15, 2018. Hamilton is preparing its financial statements for the year ended December 31, 2018. Hamilton does not make adjusting entries during the year.

Required:

For each of the situations described above, prepare the required journal entry for the **underlined entity**. If a journal entry is not required, explain why.

Answer:

1. This is a third-party reward. As the company is not an agent of the airline, revenue and expense pertaining to the award are separately recognized.

May 24, 2017	Dr. Cash	52,000	
	Cr. Parking revenue		49,600
	Cr. Award revenue (40,000 × \$0.06)		2,400

May 24, 2017	Dr. Award expense (40,000 × \$0.06)	2,400	
	Cr. Cash (40,000 × \$0.06)		2,400

2.

Dec. 31, 2018	Dr. Interest expense	180	
	Cr. Accrued interest payable		180
	\$12,000 × 7% × 78 / 365		

Diff: 2

Skill: Comp

Objective: 11.2 Describe the nature of current liabilities and account for common current liabilities including provisions; 11.3 Describe the nature of contingent assets and liabilities and account for these items; 11.4 Describe the nature of commitments and guarantees and apply accrual accounting to them.

5) P. A. Whitehorse owns a successful gardening company called Valley Gardening Ltd. (Valley). The company, which has a year end of December 31, 2015, has asked you, the company accountant, to prepare a report outlining how the following items should be reported in its financial statements.

A. On January 1, 2015, Valley took advantage of a vendor-provided financing offer to acquire computer equipment. Valley signed a \$30,000 note payable in full on January 1, 2017. Interest is payable annually at a rate of 4% per annum. Valley's bank previously advised that it would charge an interest rate of 8% per annum for a loan on similar terms.

B. A client of Valley was injured when she tripped on a piece of Valley's equipment that was in her yard. The injured party is suing Valley for \$500,000 for pain and suffering and loss of income. Valley's solicitors advise that the company will almost certainly be found liable. Based on previous verdicts, counsel estimates that there is a 50% probability that the courts will award \$400,000, and a 50% probability that the judgment will be \$200,000.

C. Valley has guaranteed \$100,000 of the indebtedness of Healthyway Inc. (HWI), a related corporation. HWI has a long record of profitability and the probability of default is thought to be remote.

D. Valley's loan agreement with the bank includes a covenant that Valley will maintain its current ratio of no less than 1.30:1. If Valley fails to meet this or any of the other covenants at year-end, all loan facilities become immediately due and payable. It appears that Valley's current ratio at year end will be slightly less than this.

Required:

Prepare the report.

Answer:

A. The liability to the vendor will be recorded at \$30,087, determined as set out below. The accrued interest of \$2,229 will be reported as a current liability, while the principal portion of \$27,859 will be reported as long-term debt.

Present value of the note at origination:

a) using a BAII PLUS financial calculator: 2 N; 8 I/Y; 30000 FV; 1,200* PMT; CPT PV PV = -26,907 rounded.

b) Using a PV table

a. $30,000 \times .8573 = 25,719$

b. $1,200 \times 1.783 = 2,140$

Total 26,907

The computer asset will be recorded at \$27,859.

* $\$30,000 \times 4\% = \$1,200$

Accrued interest to December 31, 2015 = $\$27,859 \times 8\% = \$2,229$ (rounded)

The liability to be recorded = $\$27,859 + \$2,229 = \$30,087$.

B. The loss is probable and has to be provided for. Expected value techniques may be used to determine the amount of the obligation.

Dr. Loss on lawsuit (customer injury)	300,000	
Cr. Provision for lawsuit settlement costs		300,000
[($\$400,000 \times 50\%$) + ($\$200,000 \times 50\%$) = \$300,000]		

C. IAS 39 paragraph 43 requires that the guarantee be initially reported at its fair value. The fair value considers the amount of the guarantee, the prevailing discount (interest) rate, and the probability of default. Subsequently the guarantee is measured at the higher of the best estimate to settle and the remaining provision recorded in the financial statements. IFRS 7 requires that Valley disclose the nature of the guarantee including the maximum risk exposure (\$100,000).

D. If Valley has not complied with the loan covenant at year end, the liability must be presented as a current obligation and the loan becomes due on demand. Valley should appeal to the bank for a loan waiver or extension and if accepted before year end, the loan will continue to appear as a long-term liability.

Diff: 3

Skill: Comp

Objective: 11.2 Describe the nature of current liabilities and account for common current liabilities including provisions; 11.3 Describe the nature of contingent assets and liabilities and account for these items; 11.4 Describe the nature of commitments and guarantees and apply accrual accounting to them.