

CHAPTER 13

Current Liabilities and Contingencies

ASSIGNMENT CLASSIFICATION TABLE (BY TOPIC)

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

*This material is covered in an Appendix to the chapter.

ASSIGNMENT CLASSIFICATION TABLE (BY LEARNING OBJECTIVE)

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

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	15–20
E13-3	Refinancing of short-term debt.	Simple	15–12
E13-4	Refinancing of short-term debt.	Simple	20–25
E13-5	Compensated absences.	Moderate	25–30
E13-6	Compensated absences.	Moderate	25–30
E13-7	Adjusting entry for sales tax.	Simple	5–7
E13-8	Payroll tax entries.	Simple	10–15
E13-9	Payroll tax entries.	Simple	15–20
E13-10	Warranties.	Simple	10–15
E13-11	Warranties.	Moderate	15–20
E13-12	Premium entries.	Simple	15–20
E13-13	Contingencies.	Moderate	20–30
E13-14	Asset retirement obligation.	Moderate	25–30
E13-15	Premiums.	Moderate	20–30
E13-16	Financial statement impact of liability transactions.	Moderate	30–35
E13-17	Ratio computations and discussion.	Simple	10–15
E13-18	Ratio computations and analysis.	Simple	20–25
E13-19	Ratio computations and effect of transactions.	Moderate	15–25
*E13-20	Bonus computation.	Simple	10–15
*E13-21	Bonus computation and income statement preparation.	Simple	15–20
*E13-22	Bonus compensation.	Moderate	15–20
P13-1	Current liability entries and adjustments.	Simple	25–30
P13-2	Liability entries and adjustments.	Simple	25–35
P13-3	Payroll tax entries.	Moderate	20–30
P13-4	Payroll tax entries.	Simple	20–25
P13-5	Warranties, accrual, and cash basis.	Simple	15–20
P13-6	Extended warranties.	Simple	10–20
P13-7	Warranties, accrual, and cash basis.	Moderate	25–35
P13-8	Premium entries.	Moderate	15–25
P13-9	Premium entries and financial statement presentation.	Moderate	30–45
P13-10	Loss contingencies: entries and essay.	Simple	25–30
P13-11	Loss contingencies: entries and essays.	Moderate	35–45
P13-12	Warranties and premiums.	Moderate	20–30
P13-13	Liability errors.	Moderate	25–35
*P13-14	Bonus computation.	Simple	25–30
*P13-15	Warranty, bonus, and coupon computation.	Moderate	20–25
C13-1	Nature of liabilities.	Moderate	20–25
C13-2	Current versus noncurrent classification.	Moderate	15–20
C13-3	Refinancing of short-term debt.	Moderate	30–40
C13-4	Refinancing of short-term debt.	Moderate	20–25
C13-5	Loss contingency.	Simple	15–20
C13-6	Loss contingencies.	Simple	15–20
C13-7	Warranties and loss contingencies.	Simple	15–20
C13-8	Warranties.	Moderate	20–25

ANSWERS TO QUESTIONS

1. Current liabilities are obligations whose liquidation is reasonably expected to require use of existing resources properly classified as current assets or the creation of other current liabilities. Long-term debt consists of all liabilities not properly classified as current liabilities.
2. You might explain to your friend that the accounting profession at one time prepared financial statements somewhat in accordance with the broad or loose definition of a liability submitted by the AICPA in 1953: "Something represented by a credit balance that is or would be properly carried forward upon a closing of books of account according to the rules or principles of accounting, provided such credit balance is not in effect a negative balance applicable to an asset. Thus the word is used broadly to comprise not only items which constitute liabilities in the proper sense of debts or obligations (including provision for those that are unascertained), but also credit balances to be accounted for which do not involve the debtor and creditor relation."

Since your friend may not have completely understood the above definition (if it may be called that), you might indicate that more recent definitions of liabilities call for the disbursement of assets or services in the future and that the present value of all of a person's or company's future disbursements of assets constitutes the total liabilities of that person or company. But, accountants quantify or measure only those liabilities or future disbursements which are reasonably determinable at the present time. And, accountants have accepted the completed transaction as providing the objectivity or basis necessary for financial recognition. Therefore, a liability may be viewed as an obligation to convey assets or perform services at some time in the future and is based upon a past or present transaction or event. A formal definition of liabilities presented in **Concepts Statement No. 6** is as follows: Probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.

3. As a lender of money, the banker is interested in the priority his/her claim has on the company's assets relative to other claims. Close examination of the liability section and the related footnotes discloses amounts, maturity dates, collateral, subordinations, and restrictions of existing contractual obligations, all of which are important to potential creditors. The assets and earning power are likewise important to a banker considering a loan.
4. 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.

Because current liabilities are by definition tied to current assets and current assets by definition are tied to the operating cycle, liabilities are related to the operating cycle.

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

Questions Chapter 13 (Continued)

7. A discount on notes payable represents the difference between the present value and the face value of the note, the face value being greater in amount than the discounted amount. It should be treated as an offset (contra) to the face value of the note and amortized to interest expense over the life of the note. The discount represents interest expense chargeable to future periods.
8. Liabilities that are due on demand (callable by the creditor) should be classified as a current liability. Classification of the debt as current is required because it is a reasonable expectation that existing working capital will be used to satisfy the debt. Liabilities often become callable by the creditor when there is a violation of the debt agreement. Only if it can be shown that it is probable that the violation will be cured (satisfied) within the grace period usually given in these agreements can the debt be classified as noncurrent.
9. An enterprise should exclude a short-term obligation from current liabilities only if (1) it intends to refinance the obligation on a long-term basis, and (2) it demonstrates an ability to consummate the refinancing.
10. The ability to consummate the refinancing may be demonstrated (i) by actually refinancing the short-term obligation through issuance of long-term obligation or equity securities after the date of the balance sheet but before it is issued, or (ii) by entering into a financing agreement that clearly permits the enterprise to refinance the debt on a long-term basis on terms that are readily determinable.
11. A cash dividend formally authorized by the board of directors would be recorded by a debit to Retained Earnings and a credit to Dividends Payable. The Dividends Payable account should be classified as a current liability.

An accumulated but undeclared dividend on cumulative preferred stock is not recorded in the accounts as a liability until declared by the board, but such arrearages should be disclosed either by a footnote to the balance sheet or parenthetically in the capital stock section.

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

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

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

Unearned revenues arise from the following activities:

1. The sale by a transportation company of tickets or tokens that may be exchanged or used to pay for future fares.
2. The sale by a restaurant of meal tickets that may be exchanged or used to pay for future meals.
3. The sale of gift certificates by a retail store.
4. The sale of season tickets to sports or entertainment events.
5. The sale of subscriptions to magazines.

Questions Chapter 13 (Continued)

13. Compensated absences are employee absences such as vacation, illness, and holidays for which it is expected that employees will be paid.
14. A liability should be accrued for the cost of compensated absences if all of the following conditions are met:
 - (a) The employer's obligation relating to employees' rights to receive compensation for future absences is attributable to employees' services already rendered.
 - (b) The obligation relates to employees' rights that vest or accumulate.
 - (c) Payment of the compensation is probable.
 - (d) The amount can be reasonably estimated.If an employer meets conditions (a), (b), and (c), but does not accrue a liability because of failure to meet condition (d), that fact should be disclosed.
15. An employer is required to accrue a liability for "sick pay" that employees are allowed to accumulate and use as compensated time off even if their absence is not due to illness. An employer is permitted but not required to accrue to liability for sick pay that employees are allowed to claim only as a result of actual illness.
16. Employers generally hold back from each employee's wages amounts to cover income taxes (withholding), the employee's share of FICA taxes, and other items such as union dues or health insurance. In addition, the employer must set aside amounts to cover the employer's share of FICA taxes and state and federal unemployment taxes. These latter amounts are recorded as payroll expenses and will lower Caitlin's income. In addition, the amount set aside (both the employee and the employer share) will be reported as current liabilities until they are remitted to the appropriate third party.
17.
 - (a) A contingency is defined in **FASB Statement No. 5** as an existing condition, situation, or set of circumstances involving uncertainty as to possible gain (gain contingency) or loss (loss contingency) to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur.
 - (b) A contingent liability is a liability incurred as a result of a loss contingency.
18. A contingent liability should be recorded and a charge accrued to expense only if:
 - (a) information available prior to the issuance of the financial statements indicates that it is probable that a liability has been incurred at the date of the financial statements, and
 - (b) the amount of the loss can be reasonably estimated.
19. A determinable current liability is susceptible to precise measurement because the date of payment, the payee, and the amount of cash needed to discharge the obligation are reasonably certain. There is nothing uncertain about (1) the fact that the obligation has been incurred and (2) the amount of the obligation.

A contingent liability is an obligation that is dependent upon the occurrence or nonoccurrence of one or more future events to confirm the amount payable, the payee, the date payable, or its existence. It is a liability dependent upon a "loss contingency."

Determinable current liabilities—accounts payable, notes payable, current maturities of long-term debt, dividends payable, returnable deposits, sales and use taxes, payroll taxes, and accrued expenses.

Contingent liabilities—obligations related to product warranties and product defects, premiums offered to customers, certain pending or threatened litigation, certain actual and possible claims and assessments, and certain guarantees of indebtedness of others.

Questions Chapter 13 (Continued)

20. The terms *probable*, *reasonably possible*, and *remote* are used in **FASB Statement No. 5** to denote the chances of a future event occurring, the result of which is a gain or loss to the enterprise. If it is **probable** that a loss has been incurred at the date of the financial statements, then the liability (if reasonably estimable) should be recorded. If it is **reasonably possible** that a loss has been incurred at the date of the financial statements, then the liability should be disclosed via a footnote. The footnote should disclose (1) the nature of the contingency and (2) an estimate of the possible loss or range of loss or a statement that an estimate cannot be made. If the incurrence of a loss is **remote**, then no liability need be recorded or disclosed (except for guarantees of indebtedness of others, which are disclosed even when the loss is remote).
21. Under the **cash basis method**, warranty costs are charged to expense in the period in which the seller or manufacturer performs in compliance with the warranty, no liability is recorded for future costs arising from warranties, and the period of sale is not necessarily charged with the costs of making good on outstanding warranties. Under the **accrual method**, a provision for warranty costs is made at the time of sale or as the productive activity takes place; the accrual method may be applied two different ways: expense warranty versus sales warranty method. But under either method, the attempt is to match warranty expense to the related revenues.
22. Under U.S. GAAP, companies may not record provisions for future operating losses. Such provisions do not meet the definition of a liability, since the amount is not the result of a past transaction (the losses have not yet occurred). Therefore the liability has not been incurred. Furthermore, operating losses reflect general business risks for which a reasonable estimate of the loss could not be determined. Note that use of provisions in this way is one of the examples of earnings management discussed in Chapter 4. By reducing income in good years through the use of loss contingencies, companies can smooth out their income from year-to-year.
23. The expense warranty approach and the sales warranty approach are both variations of the accrual method of accounting for warranty costs. The expense warranty approach charges the estimated future warranty costs to operating expense in the year of sale or manufacture. The sales warranty approach defers a certain percentage of the original sales price until some future time when actual costs are incurred or the warranty expires.
24. Zucker-Abrahams Airlines Inc.'s award plan is in the nature of a discounted ticket sale. Therefore, the full-fare ticket should be recorded as unearned transportation revenue (liability) when sold and recognized as revenue when the transportation is provided. The half-fare ticket should be treated accordingly; that is, record the discounted price as unearned transportation revenue (liability) when it is sold and recognize it as revenue when the transportation is provided.
25. Although the accounting for this transaction has been studied, no authoritative guideline has been developed to record this transaction. In the case of a free ticket award, AcSEC proposed that a portion of the ticket fares contributing to the accumulation of the 50,000 miles (the free ticket award level) be deferred as unearned transportation revenue and recognized as revenue when the free transportation is provided. The total amount deferred for the free ticket should be based on the revenue value to the airline and the deferral should occur and accumulate as mileage is accumulated.
26. An asset retirement obligation must be recognized when a company has an existing legal obligation associated with the retirement of a long-lived asset and when the amount can be reasonably estimated.
27. The absence of insurance does not mean that a liability has been incurred at the date of the financial statements. Until the time that an event (loss contingency) occurs there can be no diminution in the value of property or incurrence of a liability. If an event has occurred which exposes an enterprise to risks of injury to others and/or damage to the property of others, then a contingency exists. Expected future injury, damage, or loss resulting from lack of insurance need not be recorded or disclosed if no contingency exists. And, a contingency exists only if an uninsurable event which causes probable loss has occurred. Lack of insurance is not in itself a basis for recording a liability or loss.

Questions Chapter 13 (Continued)

28. In determining whether or not to record a liability for pending litigation, the following factors must be considered:
- (a) The time period in which the underlying cause for action occurred.
 - (b) The probability of an unfavorable outcome.
 - (c) The ability to make a reasonable estimate of the amount of loss.

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

- (a) The degree of probability that a suit may be filed, and
- (b) The probability of an unfavorable outcome.

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

29. There are several defensible recommendations for listing current liabilities: (1) in order of maturity, (2) according to amount, (3) in order of liquidation preference. The authors' recent review of published financial statements disclosed that a significant majority of the published financial statements examined listed "notes payable" first, regardless of relative amount, followed most often by "accounts payable," and ending the current liability section with "current portion of long-term debt."
30. The acid-test ratio and the current ratio are both measures of the short-term debt-paying ability of the company. The acid-test ratio excludes inventories and prepaid expenses on the basis that these assets are difficult to liquidate in an emergency. The current ratio and the acid-test ratio are similar in that both numerators include cash, short-term investments, and net receivables, and both denominators include current liabilities.
31. (a) A liability for goods purchased on credit should be recorded when title passes to the purchaser. If the terms of purchase are f.o.b. destination, title passes when the goods purchased arrive; if f.o.b. shipping point, title passes when shipment is made by the vendor.
- (b) Officers' salaries should be recorded when they become due at the end of a pay period. Accrual of unpaid amounts should be recorded in preparing financial statements dated other than at the end of a pay period.
- (c) A special bonus to employees should be recorded when approved by the board of directors or person having authority to approve, if the bonus is for a period of time and that period has ended at the date of approval. If the period for which the bonus is applicable has not ended but only a part of it has expired, it would be appropriate to accrue a pro rata portion of the bonus at the time of approval and make additional accruals of pro rata amounts at the end of each pay period.
- (d) Dividends should be recorded when they have been declared by the board of directors.
- (e) Usually it is neither necessary nor proper for the buyer to make any entries to reflect commitments for purchases of goods that have not been shipped by the seller. Ordinary orders, for which the prices are determined at the time of shipment and subject to cancellation by the buyer or seller, do not represent either an asset or a liability to the buyer and need not be reflected in the books or in the financial statements. However, an accrued loss on purchase commitments which results from formal purchase contracts for which a firm price is in excess of the market price at the date of the balance sheet would be shown in the liability section of the balance sheet. (See Chapter 9 on purchase commitments.)

SOLUTIONS TO BRIEF EXERCISES

BRIEF EXERCISE 13-1

July 1	Purchases	40,000	
	Accounts Payable		40,000
	Freight-in	1,200	
	Cash.....		1,200
July 3	Accounts Payable.....	6,000	
	Purchase Returns and Allowances.....		6,000
July 10	Accounts Payable.....	34,000	
	Cash (\$34,000 X 98%)		33,320
	Purchase Discounts		680

BRIEF EXERCISE 13-2

11/1/07	Cash.....	50,000	
	Notes Payable		50,000
12/31/07	Interest Expense	750	
	Interest Payable.....		750
	(\$50,000 X 9% X 2/12)		
2/1/08	Notes Payable.....	50,000	
	Interest Payable	750	
	Interest Expense	375	
	Cash		51,125
	[(\$50,000 X 9% X 3/12) + \$50,000]		

BRIEF EXERCISE 13-3

11/1/07	Cash.....	50,000	
	Discount on Notes Payable	1,125	
	Notes Payable.....		51,125
12/31/07	Interest Expense.....	750	
	Discount on Notes Payable.....		750
	(\$1,125 X 2/3)		

BRIEF EXERCISE 13-3 (Continued)

2/1/08	Interest Expense.....	375	
	Discount on Notes Payable.....		375
	Notes Payable.....	51,125	
	Cash.....		51,125

BRIEF EXERCISE 13-4

- (a) Since both criteria are met (intent and ability), none of the \$500,000 would be reported as a current liability. The entire amount would be reported as a long-term liability.
- (b) Because repayment of the note payable required the use of existing 12/31/07 current assets, the entire \$500,000 liability must be reported as current. (This assumes Fifa had not entered into a long-term agreement prior to issuance)

BRIEF EXERCISE 13-5

8/1/07	Cash.....	180,000	
	Unearned Subscription Revenue		180,000
	(10,000 X \$18)		
12/31/07	Unearned Subscription Revenue	75,000	
	Subscription Revenue.....		75,000
	(\$180,000 X 5/12 = \$75,000)		

BRIEF EXERCISE 13-6

(a)	Accounts Receivable	31,800	
	Sales		30,000
	Sales Taxes Payable.....		1,800
	(\$30,000 X 6% = \$1,800)		
(b)	Cash.....	19,610	
	Sales		18,500
	Sales Taxes Payable.....		1,110
	(\$19,610 ÷ 1.06 = \$18,500)		

BRIEF EXERCISE 13-7

Wage Expense.....	23,000	
FICA Taxes Payable.....		1,426
Federal Withholding Taxes Payable.....		2,990
State Withholding Taxes Payable.....		920
Insurance Premiums Payable.....		250
Cash.....		17,414

BRIEF EXERCISE 13-8

Wages Expense.....	36,000	
Vacation Wages Payable.....		36,000
(30 X 2 X \$600)		

BRIEF EXERCISE 13-9

12/31/07	Bonus Expense.....	450,000	
	Bonus Payable.....		450,000
2/15/08	Bonus Payable.....	450,000	
	Cash.....		450,000

BRIEF EXERCISE 13-10

(a)	Lawsuit Loss.....	700,000	
	Lawsuit Liability.....		700,000

(b) No entry is necessary. The loss is not accrued because it is not probable that a liability has been incurred at 12/31/07.

BRIEF EXERCISE 13-11

Kohlbeck should record a litigation accrual on the patent case, since the amount is both estimable and probable. This entry will reduce income by \$200,000 and Kohlbeck will report a litigation liability of \$200,000. The \$100,000 self insurance allowance has no impact on income or liabilities.

BRIEF EXERCISE 13-12

Oil Platform	500,000	
Asset Retirement Obligation		500,000

BRIEF EXERCISE 13-13

2007	Warranty Expense	70,000	
	Cash, Inventory, etc.		70,000
12/31/07	Warranty Expense	500,000	
	Estimated Liability Under Warranties.....		500,000

BRIEF EXERCISE 13-14

(a)	Cash.....	1,485,000	
	Unearned Warranty Revenue.....		1,485,000
	(15,000 X \$99)		
(b)	Warranty Expense.....	180,000	
	Cash, Inventory, etc.....		180,000
(c)	Unearned Warranty Revenue	247,500	
	Warranty Revenue.....		247,500
	(\$1,485,000 X 180/1,080*)		

*180,000 + 900,000

BRIEF EXERCISE 13-15

Premium Expense	72,000	
Estimated Liability for Premiums		72,000*

*UPC codes expected to be sent in (30% X 1,000,000)	300,000
UPC codes already redeemed	<u>120,000</u>
Estimated future redemptions	<u>180,000</u>
Cost of estimated claims outstanding	<u>\$ 72,000</u>
(180,000 ÷ 3) X (\$1.10 + \$0.60 – \$0.50)	

*BRIEF EXERCISE 13-16

$$\begin{aligned} B &= .10 (\$265,000 - B - T) \\ T &= .40 (\$265,000 - B) \\ B &= .10 [\$265,000 - B - .40(\$265,000 - B)] \\ B &= .10 [\$265,000 - B - \$106,000 + .4B] \\ B &= .10 [\$159,000 - .6B] \\ B &= \$15,900 - .06B \\ 1.06 B &= \$15,900 \\ B &= \$15,900/1.06 = \$15,000 \end{aligned}$$

SOLUTIONS TO EXERCISES

EXERCISE 13-1 (10–15 minutes)

- (a) Current liability.
- (b) Current liability.
- (c) Current liability or long-term liability depending on term of warranty.
- (d) Current liability.
- (e) Current liability.
- (f) Current liability.
- (g) Current or noncurrent liability depending upon the time involved.
- (h) Current liability.
- (i) Current liability.
- (j) Current liability.
- (k) Current liabilities or long-term liabilities as a deduction from face value of note.
- (l) Footnote disclosure (assume not probable and/or not reasonably estimable).
- (m) Current liability.
- (n) Current liability.
- (o) Footnote disclosure.
- (p) Separate presentation in either current or long-term liability section.

EXERCISE 13-2 (15–20 minutes)

(a)	Sept. 1	Purchases	50,000	
		Accounts Payable.....		50,000
	Oct. 1	Accounts Payable	50,000	
		Notes Payable		50,000
	Oct. 1	Cash	50,000	
		Discount on Notes Payable.....	4,000	
		Notes Payable		54,000
(b)	Dec. 31	Interest Expense	1,000	
		Interest Payable.....		1,000
		(\$50,000 X 8% X 3/12)		
	Dec. 31	Interest Expense	1,000	
		Discount on Notes Payable.....		1,000
		(\$4,000 X 3/12)		

EXERCISE 13-2 (Continued)

(c) (1)	Note payable	\$50,000
	Interest payable	<u>1,000</u>
		<u>\$51,000</u>
(2)	Note payable	\$54,000
	Less discount (\$4,000 – \$1,000)	<u>3,000</u>
		<u>\$51,000</u>

EXERCISE 13-3 (10–12 minutes)

Hattie McDaniel Company
Partial Balance Sheet
December 31, 2007

Current liabilities:

Notes payable (Note 1) \$250,000

Long-term debt:

Notes payable refinanced in February 2008 (Note 1) 950,000

Note 1.

Short-term debt refinanced. As of December 31, 2007, the company had notes payable totaling \$1,200,000 due on February 2, 2008. These notes were refinanced on their due date to the extent of \$950,000 received from the issuance of common stock on January 21, 2008. 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 Footnote as above.)

EXERCISE 13-4 (20–25 minutes)

**Kate Holmes Company
Partial Balance Sheet
December 31, 2007**

Current liabilities:

Notes payable (Note 1) **\$3,400,000***

Long-term debt:

Notes payable expected to be refinanced in 2008
(Note 1) **3,600,000**

Note 1.

Under a financing agreement with Gotham State 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 2012 to replace \$3,600,000 of short-term, 15%, notes due periodically in 2008. Because the amount that can be borrowed may range from \$3,600,000 to \$4,800,000, only \$3,600,000 of the \$7,000,000 of currently maturing debt has been reclassified as long-term debt.

***[\$7,000,000 – (\$6,000,000 X 60%)]**

EXERCISE 13-5 (25–30 minutes)

(a)

2006

To accrue expense and liability for compensated absences

Wages Expense	11,520	
 Vacation Wages Payable.....		7,200 (1)
 Sick Pay Wages Payable.....		4,320 (2)

To record payment for compensated time when used by employees

Sick Pay Wages Payable	2,880 (3)	
 Cash		2,880

2007

To accrue expense and liability for compensated absences

Wages Expense	12,672	
 Vacation Wages Payable.....		7,920 (4)
 Sick Pay Wages Payable.....		4,752 (5)

To record payment for compensated time when used by employers

Wages Expense	792	
Vacation Wages Payable	6,480 (6)	
Sick Pay Wages Payable	3,816 (7)	
 Cash		11,088 (8)

EXERCISE 13-5 (Continued)

(1)	9 employees X \$10.00/hr. X 8 hrs./day X 10 days =	\$7,200
(2)	9 employees X \$10.00/hr. X 8 hrs./day X 6 days =	\$4,320
(3)	9 employees X \$10.00/hr. X 8 hrs./day X 4 days =	\$2,880
(4)	9 employees X \$11.00/hr. X 8 hrs./day X 10 days =	\$7,920
(5)	9 employees X \$11.00/hr. X 8 hrs./day X 6 days =	\$4,752
(6)	9 employees X \$10.00/hr. X 8 hrs./day X 9 days =	\$6,480
(7)	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> = \$3,816
(8)	9 employees X \$11.00/hr. X 8 hrs./day X 9 days =	\$7,128
	9 employees X \$11.00/hr. X 8 hrs./day X 5 days =	<u>+3,960</u> = \$11,088

NOTE: Vacation days and sick days are paid at the employee’s current wage.

(b) Accrued liability at year-end:

	2006		2007	
	Vacation Wages Payable	Sick Pay Wages Payable	Vacation Wages Payable	Sick Pay Wages Payable
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 employees X \$10.00/hr. X 8 hrs./day X 10 days =	<u>\$7,200</u>
(2)	9 employees X \$10.00/hr. X 8 hrs./day X (6–4) days =	<u>\$1,440</u>
(3)	9 employees X \$10.00/hr. X 8 hrs./day X (10–9) days =	\$ 720
	9 employees X \$11.00/hr. X 8 hrs./day X 10 days =	<u>+7,920</u>
		<u>\$8,640</u>
(4)	9 employees X \$11.00/hr. X 8 hrs./day X (6 + 6 – 4 – 5) days	<u>\$2,376</u>

EXERCISE 13-6 (25–30 minutes)

(a)

2006

To accrue the expense and liability for vacations

Wages Expense.....	7,740 (1)	
Vacation Wages Payable		7,740

To record sick leave paid

Wages Expense.....	2,880 (2)	
Cash.....		2,880

To record vacation time paid

No entry, since no vacation days were used.

2007

To accrue the expense and liability for vacations

Wages Expense.....	8,352 (3)	
Vacation Wages Payable		8,352

To record sick leave paid

Wages Expense.....	3,960 (4)	
Cash.....		3,960

To record vacation time paid

Wage Expense.....	162	
Vacation Wages Payable.....	6,966 (5)	
Cash.....		7,128 (6)

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

(2) 9 employees X \$10.00/hr. X 8 hrs./day X 4 days = \$2,880

(3) 9 employees X \$11.60/hr. X 8 hrs./day X 10 days = \$8,352

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

(5) 9 employees X \$10.75/hr. X 8 hrs./day X 9 days = \$6,966

(6) 9 employees X \$11.00/hr. X 8 hrs./day X 9 days = \$7,128

EXERCISE 13-6 (Continued)

(b) Accrued liability at year-end:

	<u>2006</u>	<u>2007</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 13-7 (5–7 minutes)

June 30

Sales.....	21,900	
Sales Tax Payable.....		21,900
Computation:		
Sales plus sales tax (\$233,200 + \$153,700)	\$386,900	
Sales exclusive of tax (\$386,900 ÷ 1.06)	<u>365,000</u>	
Sales tax		<u>\$ 21,900</u>

EXERCISE 13-8 (10–15 minutes)

Wages and Salaries Expense	480,000	
Withholding Taxes Payable		80,000
FICA Taxes Payable*		29,900
Union Dues Payable		9,000
Cash.....		361,100
*[((\$480,000 – \$110,000) X 7.65% = \$28,305		
\$110,000 X 1.45% = \$1,595; \$28,305 + \$1,595 = \$29,900		

EXERCISE 13-8 (Continued)

Payroll Tax Expense	31,500	
FICA Taxes Payable		29,900
(See previous computation.)		
Federal Unemployment Tax Payable.....		640
[(\$480,000 – \$400,000) X .8%]		
State Unemployment Tax Payable		960
[\$80,000 X (3.5% – 2.3%)]		

EXERCISE 13-9 (15–20 minutes)

(a) Computation of taxes

	<u>Factory</u>	
Wages	\$120,000	
Social security taxes (FICA)	9,180	(7.65% X \$120,000)
Federal unemployment taxes	320	(.8% X \$40,000)
State unemployment taxes	<u>1,000</u>	(2.5% X \$40,000)
Total Cost	<u>\$130,500</u>	

	<u>Sales</u>	
Wages	\$32,000	
Social security taxes (FICA)	1,208*	
Federal unemployment taxes	32	(.8% X \$4,000)
State unemployment taxes	<u>100</u>	(2.5% X \$4,000)
Total Cost	<u>\$33,340</u>	

*\$12,000 X 7.65% = \$918; \$20,000 X 1.45% = \$290; \$918 + \$290 = \$1,208

	<u>Administrative</u>	
Wages	\$36,000	
Social security taxes (FICA)	2,754	(7.65% X \$36,000)
Federal unemployment taxes	– 0 –	
State unemployment taxes	<u>– 0 –</u>	
Total Cost	<u>\$38,754</u>	

EXERCISE 13-9 (Continued)

Schedule

	<u>Total</u>	<u>Factory</u>	<u>Sales</u>	<u>Administrative</u>
Wages	\$188,000	\$120,000	\$32,000	\$36,000
FICA	13,142	9,180	1,208	2,754
Federal U.C.	352	320	32	– 0 –
State U.C.	<u>1,100</u>	<u>1,000</u>	<u>100</u>	<u>– 0 –</u>
Total Cost	<u>\$202,594</u>	<u>\$130,500</u>	<u>\$33,340</u>	<u>\$38,754</u>

(b)

Factory Payroll:

Wages and Salaries Expense.....	120,000	
Withholding Taxes Payable.....		16,000
FICA Taxes Payable.....		9,180
Cash.....		94,820
Payroll Tax Expense.....	10,500	
FICA Taxes Payable.....		9,180
Federal Unemployment Tax Payable		320
State Unemployment Tax Payable.....		1,000

EXERCISE 13-9 (Continued)

Sales Payroll:

Wages and Salaries Expense	32,000	
Withholding Taxes Payable		7,000
FICA Taxes Payable		1,208
Cash.....		23,792
Payroll Tax Expense	1,340	
FICA Taxes Payable		1,208
Federal Unemployment Tax Payable.....		32
State Unemployment Tax Payable		100

Administrative Payroll:

Wages and Salaries Expense	36,000	
Withholding Taxes Payable		6,000
FICA Taxes Payable		2,754
Cash.....		27,246
Payroll Tax Expense	2,754	
FICA Taxes Payable		2,754

EXERCISE 13-10 (10–15 minutes)

(a) Cash (200 X \$4,000).....	800,000	
Sales		800,000
Warranty Expense	17,000	
Cash.....		17,000
Warranty Expense (\$66,000* – \$17,000)	49,000	
Estimated Liability Under Warranties.....		49,000
*(200 X \$330)		
(b) Cash	800,000	
Sales		800,000
Warranty Expense	17,000	
Cash.....		17,000

EXERCISE 13-11 (15–20 minutes)

(a) Cash.....	3,000,000	
Sales		3,000,000
(500 X \$6,000)		
Warranty Expense.....	20,000	
Cash		20,000
Warranty Expense.....	100,000	
Estimated Liability Under Warranties.....		100,000
(\$120,000 – \$20,000)		
(b) Cash.....	3,000,000	
Sales		2,850,000
Unearned Warranty Revenue.....		150,000
Warranty Expense.....	20,000	
Cash		20,000
Unearned Warranty Revenue	25,000	
Warranty Revenue.....		25,000
[\$150,000 X (\$20,000/\$120,000)]		

EXERCISE 13-12 (15–20 minutes)

Inventory of Premiums (8,800 X \$.80)	7,040	
Cash.....		7,040
Cash (110,000 X \$3.30)	363,000	
Sales		363,000
Premium Expense.....	3,520	
Inventory of Premiums [(44,000 ÷ 10) X \$.80]		3,520
Premium Expense.....	1,760*	
Estimated Liability for Premiums		1,760

*[(110,000 X 60%) – 44,000] ÷ 10 X \$.80 = 1,760

EXERCISE 13-13 (20–30 minutes)

1. The FASB requires that, when some amount within the range of expected loss appears at the time to be a better estimate than any other amount within the range, that amount is accrued. When no amount within the range is a better estimate than any other amount, the dollar amount at the low end of the range is accrued and the dollar amount at the high end of the range is disclosed. In this case, therefore, Salt-n-Pepa Inc. would report a liability of \$900,000 at December 31, 2007. (See *FIN14: Reasonable Estimation of the Amount of a Loss: An Interpretation of SFAS No. 5.*)
2. The loss should be accrued for \$5,000,000. The potential insurance recovery is a gain contingency—it is not recorded until received.
3. This is a gain contingency because the amount to be received will be in excess of the book value of the plant. Gain contingencies are not recorded and are disclosed only when the probabilities are high that a gain contingency will become reality.

EXERCISE 13-14 (25–30 minutes)

(a)	Depot.....	600,000	
	Cash.....		600,000
	Depot.....	41,879	
	Asset Retirement Obligation		41,879
(b)	Depreciation Expense	60,000	
	Accumulated Depreciation.....		60,000
	Depreciation Expense	4,187.90	
	Accumulated Depreciation.....		4,187.90*
	Interest Expense	2,512.74	
	Asset Retirement Obligation		2,512.74**

*\$41,879/10.

**\$41,879 X .06.

EXERCISE 13-14 (Continued)

(c) Asset Retirement Obligation	75,000	
Loss on ARO Settlement	5,000	
Cash		80,000

EXERCISE 13-15 (25–35 minutes)

1. Liability for stamp redemptions, 12/31/06	\$13,000,000
Cost of redemptions redeemed in 2007	<u>(6,000,000)</u>
	7,000,000
Cost of redemptions to be redeemed in 2008	
(5,200,000 X 80%)	<u>4,160,000</u>
Liability for stamp redemptions, 12/31/07	<u>\$11,160,000</u>
2. 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>\$528,000</u>
Total cost	\$528,000
Total payments to retailers	<u>330,000</u>
Liability for unredeemed coupons	<u>\$198,000</u>
3. Boxes	700,000
Redemption rate	<u>70%</u>
Total redeemable	<u>490,000</u>
Coupons to be redeemed (490,000 – 250,000)	240,000
Cost (\$6.50 – \$4.00)	<u>\$2.50</u>
Liability for unredeemed coupons	<u>\$600,000</u>

EXERCISE 13-16 (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	I	I	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

EXERCISE 13-17 (15–20 minutes)

$$(a) \quad \text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\$210,000}{\$80,000} = 2.63$$

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

$$(b) \quad \text{Acid-test ratio} = \frac{\text{Cash} + \text{Short-term Investments} + \text{Net Receivables}}{\text{Current Liabilities}} = \frac{\$115,000}{\$80,000} = 1.44$$

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

$$(c) \quad \text{Debt to total assets} = \frac{\text{Total Liabilities}}{\text{Total Assets}} = \frac{\$220,000}{\$430,000} = 51.16\%$$

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

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

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

EXERCISE 13-18 (20–25 minutes)

$$(a) \quad (1) \quad \text{Current ratio} = \frac{\$773,000}{\$240,000} = 3.22 \text{ times}$$

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

EXERCISE 13-18 (Continued)

- (3) Accounts receivable turnover =
$$\$1,640,000 \div \frac{\$80,000 + \$198,000}{2} = 11.8 \text{ times (or approximately every 31 days)}$$
- (4) Inventory turnover =
$$\$800,000 \div \frac{\$360,000 + \$440,000}{2} = 2 \text{ times (or approximately every 183 days)}$$
- (5) Rate of return on assets =
$$\$360,000 \div \frac{\$1,400,000 + \$1,630,000}{2} = 23.76\%$$
- (6) Profit margin on sales =
$$\$360,000 \div \$1,640,000 = 21.95\%$$
- (b) Financial ratios should be evaluated in terms of industry peculiarities and prevailing business conditions. Although industry and general business conditions are unknown in this case, the company appears to have a relatively strong current position. The main concern from a short-term perspective is the apparently low inventory turnover. The rate of return on assets and profit margin on sales are extremely good and indicate that the company is employing its assets advantageously.

EXERCISE 13-19 (15–25 minutes)

- (a) (1) $\$318,000 \div \$87,000 = 3.66 \text{ times}$
- (2) $\$820,000 \div \frac{\$200,000 + \$170,000}{2} = 4.43 \text{ times} = 82 \text{ days}$
- (3) $\$1,400,000 \div \$95,000 = 14.74 \text{ times} = 25 \text{ days}$

EXERCISE 13-19 (Continued)

- (4) $\$410,000 \div 52,000 = \7.88
- (5) $\$410,000 \div \$1,400,000 = 29.3\%$
- (6) $\$410,000 \div \$488,000 = 84.02\%$
- (b) (1) No effect on current ratio, if already included in the allowance for doubtful accounts.
- (2) Weaken current ratio by reducing current assets.
- (3) Improve current ratio by reducing current assets and current liabilities by a like amount.
- (4) No effect on current ratio.
- (5) Weaken current ratio by increasing current liabilities.
- (6) No effect on current ratio.

*EXERCISE 13-20 (10–15 minutes)

(B = bonus; T = taxes)

(a)

$$B = .15 (\$299,750 - B - T)$$
$$T = .40 (\$299,750 - B)$$
$$B = .15 [\$299,750 - B - .4 (\$299,750 - B)]$$
$$B = .15 (\$299,750 - B - \$119,900 + .4B)$$
$$B = .15 (\$179,850 - .6B)$$
$$B = \$26,977.50 - .09B$$
$$1.09B = \$26,977.50$$
$$\text{Bonus} = \$24,750$$

(b)

$$T = .40 (\$299,750 - B)$$
$$T = .40 (\$299,750 - \$24,750)$$
$$T = .40 (\$275,000)$$
$$\text{Taxes} = \$110,000$$

(c)	Bonus Expense.....	24,750	
	Bonus Payable		24,750

***EXERCISE 13-21 (15–20 minutes)**

Scottie Pippen Company
Income Statement
For the Year Ended December 31, 2007

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>198,198</u>	<u>1,198,198</u>
Income before income taxes		1,801,802
Income taxes (45%)		<u>810,811</u>
Net income		<u>\$ 990,991</u>

Computation of bonus and tax:

$$T = .45 (\$3,000,000 - \$1,000,000 - B)$$

$$B = .20 (\$2,000,000 - B - T)$$

$$B = .20 [\$2,000,000 - B - .45 (\$2,000,000 - B)]$$

$$B = .20 (\$2,000,000 - B - \$900,000 + .45B)$$

$$B = .20 (\$1,100,000 - .55B)$$

$$B = \$220,000 - .11B$$

$$1.11B = \$220,000$$

$$\text{Bonus} = \$198,198.19$$

$$T = .45 (\$2,000,000 - \$198,198.19)$$

$$T = .45 (\$1,801,801.81)$$

$$\text{Taxes} = \$810,810.81$$

***EXERCISE 13-22 (15–20 minutes)**

C = Contribution; T = Tax

$$T = .40 (\$300,000 - C)$$

$$C = .25 [\$300,000 - C - T - .10 (\$700,000 + \$300,000 - C - T)]$$

$$C = .25 [\$300,000 - C - .40 (\$300,000 - C) - .10 [\$700,000 + \$300,000 - C - .40 (\$300,000 - C)]]$$

$$C = .25 (\$300,000 - C - \$120,000 + .40C - \$70,000 - \$30,000 + .10C + \$12,000 - .04C)$$

$$C = \$75,000 - .25C - \$30,000 + .10C - \$17,500 - \$7,500 + .025C + \$3,000 - .01C$$

$$C = \$23,000 - .135C$$

$$1.135C = \$23,000$$

$$C = \$20,264.32$$

TIME AND PURPOSE OF PROBLEMS

Problem 13-1 (Time 25–30 minutes)

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

Problem 13-2 (Time 25–35 minutes)

Purpose—to present the student with the opportunity to prepare journal entries for several different situations related to liabilities. The situations presented include accruals and payments related to sales, use, and asset retirement obligations. Year-end adjusting entries are also required.

Problem 13-3 (Time 20–30 minutes)

Purpose—to present the student with an opportunity to prepare journal entries for four weekly payrolls. The student must compute income tax to be withheld, FICA tax, and state and federal unemployment compensation taxes. The student must realize the fact that in the fourth week only a portion of one employee's payroll is subject to unemployment tax.

Problem 13-4 (Time 20–25 minutes)

Purpose—to provide the student with the opportunity to prepare journal entries for a monthly payroll. The student must compute income tax to be withheld, FICA tax, and state and federal unemployment compensation taxes. The student must be aware that the unemployment taxes do not apply to three employees as their earnings exceed the statutory maximum subject to the taxes.

Problem 13-5 (Time 15–20 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 warranty accrual methods. Entries in the sales year and one subsequent year are required. The problem highlights the differences between the two methods in the accounts and on the balance sheet.

Problem 13-6 (Time 10–20 minutes)

Purpose—to provide the student with a basic problem covering the sales warranty method. The student is required to prepare journal entries in the year of sale and in subsequent years when warranty costs are incurred. Also required are balance sheet presentations for the year of sale and one subsequent year. While the problem is basic in nature it does test the student's ability to understand and apply the sales warranty method.

Problem 13-7 (Time 25–35 minutes)

Purpose—to provide the student with an opportunity to prepare journal entries for warranty costs under the expense warranty method and the cash basis method. The student is also required to indicate the proper balance sheet disclosures under each method for the year of sale. Finally, the student is required to comment on the effect on net income of applying each method. The problem highlights the differences between the two methods in the accounts and on the balance sheet.

Problem 13-8 (Time 15–25 minutes)

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

Problem 13-9 (Time 30–45 minutes)

Purpose—to present the student with a slightly complicated problem related to accounting for premium offers. The problem is more complicated in that coupons redeemed are accompanied by cash payments, and in addition to the cost of the premium item postage costs are also incurred. The student

Time and Purpose of Problems (Continued)

is required to prepare journal entries for various transactions including sales, purchase of the premium inventory, and redemption of coupons for two years. The second year's entries are more complicated due to the existence of the liability for claims outstanding. Finally the student is required to indicate the amounts related to the premium offer that would be included in the financial statements for each of two years. This very realistic problem challenges the student's ability to account for all transactions related to premium offers.

Problem 13-10 (Time 25–30 minutes)

Purpose—to present the student with the problem of determining the proper amount of and disclosure for a contingent loss due to lawsuits. The student is required to prepare a journal entry and a footnote. The student is also required to discuss any liability incurred by a company due to the risk of loss from lack of insurance coverage. A straightforward problem dealing with contingent losses.

Problem 13-11 (Time 35–45 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 three independent situations. For each situation the student must also discuss the appropriate disclosure in the financial statements. The situations presented include a lawsuit, an expropriation, and a self-insurance situation. This problem challenges the student not only to apply the guidelines set forth in **FASB Statement No. 5**, but also to develop reasoning as to how the guidelines relate to each situation. A good problem to analyze the effects of **FASB Statement No. 5** on a variety of situations.

Problem 13-12 (Time 20–30 minutes)

Purpose—the student calculates warranty expense, estimated liability for warranties, premium expense, inventory of premiums, and estimated liability for premiums.

Problem 13-13 (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 contingencies, warranties, and litigation.

***Problem 13-14** (Time 25–30 minutes)

Purpose—to provide the student with experience in computing bonuses under a variety of compensation plans. The student must compute a bonus before deduction of bonus and income taxes, after deduction of bonus but before deduction of income taxes, before deduction of bonus but after deduction of income taxes, and after deduction of bonus and income tax. This problem presents all the basic bonus computations.

***Problem 13-15** (Time 20–25 minutes)

Purpose—to present the student with a comprehensive problem in determining the amounts of various liabilities. The student must calculate (for independent situations) the estimated liability for warranties, a bonus-type profit-sharing contribution, and an estimated liability for premium claims outstanding. Journal entries are not required. This problem should challenge the better students.

SOLUTIONS TO PROBLEMS

PROBLEM 13-1

(a)			
	February 2		
	Purchases (\$50,000 X 98%).....	49,000	
	Accounts Payable.....		49,000
	February 26		
	Accounts Payable	49,000	
	Purchase Discounts Lost	1,000	
	Cash		50,000
	April 1		
	Trucks.....	40,000	
	Cash		4,000
	Notes Payable		36,000
	May 1		
	Cash.....	86,000	
	Discount on Notes Payable.....	6,000	
	Notes Payable		92,000
	August 1		
	Retained Earnings (Dividends Declared)	300,000	
	Dividends Payable.....		300,000
	September 10		
	Dividends Payable.....	300,000	
	Cash		300,000
(b)	December 31		
	1. No adjustment necessary		
	2. Interest Expense (\$36,000 X 12% X 9/12)	3,240	
	Interest Payable		3,240
	3. Interest Expense (\$6,000 X 8/12).....	4,000	
	Discount on Notes Payable.....		4,000
	4. No adjustment necessary		

PROBLEM 13-2

1.	Dec. 5	Cash Returnable Deposit (Liability)	500 		
					500
2.	Dec. 1-31	Cash Sales ($\\$834,750 \div 1.05$) Sales Taxes Payable ($\\$795,000 \times .05$)	834,750 		
				795,000	39,750
3.	Dec. 10	Trucks ($\\$99,000 \times 1.05$) Cash	103,950 		
					103,950
4.	Dec. 31	Parking Lot Asset Retirement Obligation	84,000 		
					84,000

PROBLEM 13-3

Entries for Payroll 1

Wages and Salaries Expense	980.00*	
Withholding Taxes Payable (10% X \$980)*		98.00
FICA Taxes Payable (7.65% X \$980)		74.97
Union Dues Payable (2% X \$980)		19.60
Cash		787.43

***\$180 + \$150 + \$110 + \$250 + \$290 = \$980**

Payroll Tax Expense	89.49	
FICA Taxes Payable (7.65% X \$980)		74.97
Federal Unemployment Tax Payable		3.52
[.8% X (\$180 + \$150 + \$110)]		
State Unemployment Tax Payable		11.00
(2.5% X \$440)		

Entries for Payroll 2 and 3

Vacation Wages Payable	550.00*	
Wages and Salaries Expense	430.00	
Withholding Taxes Payable (10% X \$980)		98.00
FICA Taxes Payable (7.65% X \$980)		74.97
Union Dues Payable (2% X \$980)		19.60
Cash		787.43

***(\$300 + \$220 + \$580) ÷ 2**

Payroll Tax Expense	89.49	
FICA Taxes Payable (7.65% X \$980)		74.97
Federal Unemployment Tax Payable		3.52
(.8% X \$440)		
State Unemployment Tax Payable		11.00
(2.5% X \$440)		

PROBLEM 13-3 (Continued)

Entries for Payroll 4

Wages and Salaries Expense	980.00	
Withholding Taxes Payable (10% X \$980).....		98.00
FICA Taxes Payable (7.65% X \$980).....		74.97
Union Dues Payable (2% X \$980).....		19.60
Cash.....		787.43
Payroll Tax Expense	89.49	
FICA Taxes Payable (7.65% X \$980).....		74.97
Federal Unemployment Tax Payable		3.52
(.8% X \$440)		
State Unemployment Tax Payable.....		11.00
(2.5% X \$440)		

Monthly Payment of Payroll Liabilities

Withholding Taxes Payable (\$98.00 X 4).....	392.00	
FICA Taxes Payable (\$74.97 X 8)	599.76	
Union Dues Payable (\$19.60 X 4).....	78.40	
Federal Unemployment Tax Payable (\$3.52 X 4).....	14.08	
State Unemployment Tax Payable (\$11.00 X 4)	44.00	
Cash.....		1,128.24

PROBLEM 13-4

(a)

Name	Earnings to Aug. 31	September Earnings	Income Tax Withholding	FICA	State U.C.	Federal U.C.
B. D. Williams	\$ 6,800	\$ 800	\$ 80	\$ 61.20	\$2.00*	\$1.60**
D. Prowse	6,300	700	70	53.55	7.00***	5.60****
K. Baker	7,600	1,100	110	84.15	-	-
F. Oz	13,600	1,900	190	145.35	-	-
A. Daniels	105,000	15,000	1,500	217.50 ^a	-	-
B. Mayhew	<u>112,000</u>	<u>16,000</u>	<u>1,600</u>	<u>232.00^b</u>	-	-
Total	<u>\$251,300</u>	<u>\$35,500</u>	<u>\$3,550</u>	<u>\$793.75</u>	<u>\$9.00</u>	<u>\$7.20</u>

*(\$7,000 – \$6,800) X 1% = \$2.00 ^a\$15,000 X 1.45% = \$217.50
 **(\$7,000 – \$6,800) X .8% = \$1.60 ^b\$16,000 X 1.45% = \$232.00
 ***(\$7,000 – \$6,300) X 1% = \$7.00
 ****(\$7,000 – \$6,300) X .8% = \$5.60

Wages and Salaries Expense	35,500.00	
Withholding Taxes Payable		3,550.00
FICA Taxes Payable		793.75
Cash.....		31,156.25
(b) Payroll Tax Expense	809.95	
FICA Taxes Payable		793.75
Federal Unemployment Tax Payable.....		7.20
State Unemployment Tax Payable		9.00
(c) Withholding Taxes Payable.....	3,550.00	
FICA Taxes Payable	1,587.50	
Federal Unemployment Tax Payable.....	7.20	
State Unemployment Tax Payable	9.00	
Cash.....		5,153.70

PROBLEM 13-5

(a)	Cash (300 X \$3,500).....	1,050,000	
	Sales		1,050,000
(b)	Cash (300 X \$3,500).....	1,050,000	
	Sales		1,050,000
	Warranty Expense (300 X [\$155 + \$185]).....	102,000	
	Estimated Liability Under Warranties.....		102,000
(c)	No liability would be disclosed under the cash basis method relative to future costs due to warranties on past sales.		
(d)	Current Liabilities:		
	Estimated Liability Under Warranties.....		\$51,000
	Long-term Liabilities:		
	Estimated Liability Under Warranties.....		\$51,000
(e)	Warranty Expense.....	46,300	
	Parts Inventory		21,400
	Accrued Payroll.....		24,900
(f)	Estimated Liability Under Warranties.....	46,300	
	Parts Inventory		21,400
	Accrued Payroll.....		24,900

PROBLEM 13-6

(a)	Cash	245,250	
	Sales (300 X \$750).....		225,000
	Unearned Warranty Revenue (270 X \$75).....		20,250
(b)	Current Liabilities:		
	Unearned Warranty Revenue (\$20,250/3)		\$ 6,750
	(Note: Warranty costs assumed to be incurred equally over the three-year period)		
	Long-term Liabilities:		
	Unearned Warranty Revenue (\$20,250 X 2/3)		\$13,500
(c)	Unearned Warranty Revenue.....	6,750	
	Warranty Revenue		6,750
	Warranty Expense	5,000	
	Parts Inventory.....		2,000
	Accrued Payroll		3,000
(d)	Current Liabilities:		
	Unearned Warranty Revenue		\$ 6,750
	Long-term Liabilities:		
	Unearned Warranty Revenue		\$ 6,750

PROBLEM 13-7

(a)	(1)	Cash or Accounts Receivable	4,810,000	
		Sales (650 X \$7,400).....		4,810,000
	(2)	Warranty Expense	120,250	
		Parts Inventory (\$170 X 650 X 1/2)		55,250
		Accrued Payroll (\$200 X 650 X 1/2).....		65,000
		(\$120,250 = $\frac{650 \times \$370}{2}$)		

(3)		Warranty Expense	120,250	
		Estimated Liability Under Warranties...		120,250
		(650 machines X \$370) – \$120,250		

(4)		Estimated Liability Under Warranties	120,250	
		Parts Inventory		55,250
		Accrued Payroll.....		65,000

(b)	(1)	Cash	4,810,000	
		Sales		4,810,000
	(2)	Warranty Expense	120,250	
		Parts Inventory		55,250
		Accrued Payroll.....		65,000

(3) Under the cash basis method, the total warranty expense is recorded through entries 2 and 4 which recognize warranty costs as incurred. Warranty expense for 2008 is \$120,250 under the cash basis.

(4)		Warranty Expense	120,250	
		Parts Inventory		55,250
		Accrued Payroll.....		65,000

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

PROBLEM 13-7 (Continued)

Expense warranty accrual method:

As of 12/31/08 the balance sheet would disclose a current liability in the amount of \$120,250 for Estimated Liability Under Warranties.

- (d) In the case of Albert Pujols Company, the expense warranty accrual method reflects properly the income resulting from operations in 2008 and 2009 because the warranty costs are matched with the revenues resulting from the sale, which required such costs to be incurred. Under the cash basis method, the warranty costs appearing on the 2009 income statement are charged against unrelated revenues; 2008 net income is overstated and 2009 net income is understated.**

PROBLEM 13-8

Inventory of Premium Puppets	60,000	
Cash.....		60,000
(To record purchase of 40,000 puppets at \$1.50 each)		
Cash	1,650,000	
Sales		1,650,000
(To record sales of 440,000 boxes at \$3.75 each)		
Premium Expense.....	31,500	
Inventory of Premium Puppets.....		31,500
[To record redemption of 105,000 coupons. Computation: $(105,000 \div 5) \times \$1.50 = \$31,500$]		
Premium Expense.....	21,300	
Estimated Liability for Premiums		21,300
[To record estimated liability for premium claims outstanding at December 31, 2008.]		
Computation: Total coupons issued in 2008		<u>440,000</u>
Total estimated redemptions (40%)		176,000
Coupons redeemed in 2008		<u>105,000</u>
Estimated future redemptions		<u>71,000</u>
Cost of estimated claims outstanding $(71,000 \div 5) \times \\$1.50 = \\$21,300$		

PROBLEM 13-9

(a) 2007

Inventory of Premium CDs	450,000	
Cash		450,000
(To record the purchase of 250,000 CDs at \$1.80 each)		
 Cash	 868,620	
Sales		868,620
(To record the sale of 2,895,400 candy bars at 30 cents each)		
 Cash [\$480,000 – (240,000 X .30)]	 408,000	
Premium Expense	24,000	
Inventory of Premium CDs		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]		
 Computation of premium expense:		
240,000 CDs @ \$1.80 each =	\$432,000	
Postage—240,000 X \$.30 =	<u>72,000</u>	
	\$504,000	
Less: Cash received—		
240,000 X \$2.00	<u>480,000</u>	
Premium expense for CDs issued	<u>\$ 24,000</u>	
 Premium Expense	 5,800*	
Estimated Liability for Premiums		5,800
(To record the estimated liability for premium claims outstanding at 12/31/07)		
*(290,000 ÷ 5) X (\$1.80 + \$.30 – \$2.00) = \$5,800		

PROBLEM 13-9 (Continued)

2008

Inventory of Premium CDs.....	594,000	
Cash.....		594,000
(To record the purchase of 330,000 CDs at \$1.80 each)		
 Cash	823,080	
Sales		823,080
(To record the sale of 2,743,600 candy bars at 30 cents each)		
 Cash (\$600,000 – \$90,000).....	510,000	
Estimated Liability for Premiums	5,800	
Premium Expense.....	24,200	
Inventory of Premium CDs.....		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.)		
 Computation of premium expense:		
300,000 CDs @ \$1.80 =.....	\$540,000	
Postage—300,000 @ .30 =	90,000	
	<u>630,000</u>	
Less: Cash received—		
(1,500,000 ÷ 5) X \$2.00.....	<u>600,000</u>	
Premium expense for CDs issued.....	30,000	
Less: Outstanding claims at 12/31/07 charged to 2007 but redeemed in 2008.....	<u>5,800</u>	
Premium expense chargeable to 2008.....	<u>\$ 24,200</u>	
 Premium Expense.....	\$ 7,000*	
Estimated Liability for Premiums		7,000
*(350,000 ÷ 5) X (\$1.80 + \$.30 – \$2.00) = \$7,000		

PROBLEM 13-9 (Continued)

(b) Account	Amount		Classification
	2007	2008	
Inventory of Premium CDs	\$18,000*	\$72,000**	Current asset
Estimated Liability for Premiums	5,800	7,000	Current liability
Premium Expense	29,800***	31,200****	Selling expense

***\$1.80 (250,000 – 240,000)**

****\$1.80 (10,000 + 330,000 – 300,000)**

*****\$24,000 + \$5,800**

******\$24,200 + \$7,000**

PROBLEM 13-10

- (a) Because the cause for litigation occurred before the date of the financial statements and because an unfavorable outcome is probable and reasonably estimable, Branson Airlines should report a loss and a liability in the December 31, 2007, financial statements. The loss and liability might be recorded as follows:

Loss from Uninsured Accident		
(\$5,000,000 X 60%).....	3,000,000	
Liability for Uninsured Accident.....		3,000,000

Note to the Financial Statements

Due to an accident which occurred during 2007, the Company is a defendant in personal injury suits totaling \$5,000,000. The Company is charging the year of the casualty with \$3,000,000 in estimated losses, which represents the amount that the company legal counsel estimates will finally be awarded.

- (b) Branson Airlines need not establish a liability for risk of loss from lack of insurance coverage itself. FASB Statement No. 5 does not require or allow the establishment of a liability for expected future injury to others or damage to the property of others even if the amount of the losses is reasonably estimable. The cause for a loss must occur on or before the balance sheet date for a loss contingency to be recorded. However, the fact that Branson is self-insured should be disclosed in a note.

PROBLEM 13-11

(a)	1.	Loss from Uninsured Accident.....	225,000	
		Liability for Uninsured Accident.....		225,000
	2.	Loss from Expropriation.....	2,245,000	
		Allowance for Expropriation.....		2,245,000
		[\$5,725,000 – (40% X \$8,700,000)]		
	3.	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 probable 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 attorney's estimate of probable loss required recognition of a loss contingency.
2. An entry to record a loss and establish an allowance due to threat of expropriation is necessary because the expropriation is imminent as evidenced by the foreign government's communicated intent to expropriate and the prior settlements for properties already expropriated. That is, 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 amount that the carrying value (book value) of the assets exceeds the expected compensation. At the time the expropriation occurs, the related assets are written off against the allowance account. In this problem, we established a valuation account because certain specific assets were impaired. A valuation account was established rather than a liability account because the net realizability of the assets affected has decreased. A more appropriate presentation would, therefore, be provided for balance sheet purposes on the realizability of the assets. It does not seem appropriate at this point to write off the assets involved because it may be difficult to determine all the specific assets involved, and because the assets still have not been expropriated.

PROBLEM 13-11 (Continued)

3. Even though Ichiro'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 unfavorable outcome.

PROBLEM 13-12

(1)	Sales of musical instruments and sound equipment	\$5,400,000
	Estimated warranty cost	<u>.02</u>
	Warranty expense for 2007	<u>\$ 108,000</u>
(2)	Estimated liability for warranties—1/1/07	\$ 136,000
	2007 warranty expense (Requirement 1)	<u>108,000</u>
	Subtotal	244,000
	Actual warranty costs during 2007	<u>164,000</u>
	Estimated liability from warranties—12/31/07	<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 cassette player)	<u>÷ 200</u>
	Estimated number of premium cassette players to be issued	5,400
	Net cost of cassette players (\$34 – \$20)	<u>14</u>
	Premium expense for 2007	<u>\$ 75,600</u>
(4)	Inventory of premium cassette players—1/1/07	\$ 39,950
	Premium cassette players purchased during 2007 (6,500 X \$34)	<u>221,000</u>
	Premium cassette players available	260,950
	Premium cassette players exchanged for coupons during 2007 (1,200,000/200 X \$34)	<u>\$ 204,000</u>
	Inventory of premium cassette players—12/31/07	<u>\$ 56,950</u>
(5)	Estimated liability for premiums—1/1/07	\$ 44,800
	2007 premium expense (Requirement 3)	<u>\$ 75,600</u>
	Subtotal	\$ 120,400
	Actual redemptions during 2007 [1,200,000/200 X (\$34 – \$20)]	<u>\$ 84,000</u>
	Estimated liability for premiums—12/31/07	<u>\$ 36,400</u>

PROBLEM 13-13

1. Memo prepared by:
Date:

**Christine Agazzi Corporation
December 31, 2007**

Recognition of Warranty Expense

During June of this year, the client began 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.

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

Because Agazzi accounts for warranties on the accrual basis, it must recognize the entire \$2,500,000 as warranty expense in the year of sale. I advised the client to make the following journal entries:

- (a)

Cash/Accounts Receivable.....	50,000,000	
Sales (100,000 X \$500).....		50,000,000
(To record sale of 100,000 dishwashers)		

- (b)

Warranty Expense.....	1,000,000	
Cash, Inventory, Accrued Payroll		1,000,000
(To record warranty costs incurred)		

- (c)

Warranty Expense.....	1,500,000	
[(100,000 X \$25) – \$1,000,000]		
Estimated Liability Under Warranties		1,500,000
(To accrue estimated warranty costs)		

PROBLEM 13-13 (Continued)

2.

**Memo prepared by:
Date:**

**Christine Agazzi Corporation
December 31, 2007**

**Loss Contingency from Violation
Of EPA Regulations**

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

Although the litigation is pending, Sklodowski believes that the suit will probably be lost. A reasonable estimate of clean up costs and fines is \$3,330,000. The client neither disclosed nor accrued this loss in the financial statements.

Because this loss is both probable and reasonably estimable, it must be accrued as a contingent liability. I advised the client to record the following entry to accrue this liability.

Loss from Environmental Cleanup	3,330,000	
 Liability for Environmental Cleanup		3,330,000

PROBLEM 13-13 (Continued)

3.

Memo prepared by:

Date:

**Christine Agazzi Corporation
December 31, 2007**

**Loss Contingency on
Patent Infringement Litigation**

In answer to my attorney letter requesting information about any possible litigation associated with the client, Robert Sklodowski informed me that the client is in the middle of a patent infringement suit with Heidi Goldman over a hydraulic compressor used in several of Agazzi's appliances. The possible loss of this suit is only reasonably possible. Agazzi did not in any way disclose this information.

Because the loss is reasonably possible and can be estimated at \$5,000,000, it must be disclosed in the notes to the financial statements. I advised the client to include as a footnote to the financial statements a discussion of this pending litigation along with the attorney's assessment that the loss is reasonably possible. In addition, I advised the client to disclose the estimated amount of this loss contingency.

***PROBLEM 13-14**

(B = bonus; T = taxes)

(a)

$$\begin{aligned} B &= 0.12 (\$250,000) \\ B &= \$30,000 \\ T &= .40 (\$250,000 - \$30,000) \\ T &= \$88,000 \\ &= \end{aligned}$$

(b)

$$\begin{aligned} B &= 0.12 (\$308,000 - B) \\ B &= \$36,960 - .12B \\ 1.12B &= \$36,960 \\ B &= \$33,000 \\ T &= 0.40 (\$308,000 - \$33,000) \\ T &= \$110,000 \end{aligned}$$

(c)

$$\begin{aligned} B &= 0.12 (\$350,000 - T) \\ T &= 0.40 (\$350,000 - B) \\ B &= 0.12 [\$350,000 - 0.40 (\$350,000 - B)] \\ B &= 0.12 (\$350,000 - \$140,000 + .4B) \\ B &= \$25,200 + .048B \\ 0.952B &= \$25,200 \\ B &= \$26,470.59 \\ T &= .40 (\$350,000 - \$26,470.59) \\ T &= \$129,411.76 \end{aligned}$$

(d)

$$\begin{aligned} B &= 0.12 (\$380,000 - B - T) \\ T &= 0.40 (\$380,000 - B) \\ B &= 0.12 [\$380,000 - B - .40 (\$380,000 - B)] \\ B &= 0.12 (\$380,000 - B - \$152,000 + 0.4B) \\ B &= 0.12 (\$228,000 - 0.6B) \\ B &= \$27,360 - .072B \\ 1.072B &= \$27,360 \\ B &= \$25,522.39 \\ T &= 0.40 (\$380,000 - \$25,522.39) \\ T &= \$141,791.04 \end{aligned}$$

PROBLEM 13-15

1. Estimated warranty costs:

On 2005 sales \$ 800,000 X .09	\$ 72,000
On 2006 sales \$1,100,000 X .09	99,000
On 2007 sales \$1,200,000 X .09	<u>108,000</u>
Total estimated costs	279,000
Total warranty expenditures	<u>85,700*</u>
Balance of liability, 12/31/07	<u>\$193,300</u>

*2005—\$6,500; 2006—\$17,200, and 2007—\$62,000.

The liability account has a balance of \$193,300 at 12/31/07 based on the difference between the estimated warranty costs (totaling \$279,000) for the three years' sales and the actual warranty expenditures (totaling \$85,700) during that same period.

*2.

$$\begin{aligned} \text{Tax} &= .40 (\$1,035,000 - C) \\ \text{Contribution} &= .25 (\$1,035,000 - C - T) \\ C &= .25 [\$1,035,000 - C - .40 (\$1,035,000 - C)] \\ C &= .25 (\$1,035,000 - C - \$414,000 + .40C) \\ C &= .25 (\$621,000 - .6C) \\ C &= \$155,250 - .15C \\ 1.15C &= \$155,250 \\ C &= \$135,000 \end{aligned}$$

3. Computation of liability for premium claims outstanding:

Unredeemed coupons for 2007	
(\$9,000 - \$8,000)	\$ 1,000
2007 coupons estimated to be redeemed	
(\$25,000 X .40)	<u>10,000</u>
Total	<u>\$11,000</u>

TIME AND PURPOSE OF CONCEPTS FOR ANALYSIS

CA 13-1 (Time 20–25 minutes)

Purpose—to provide the student with the opportunity to define a liability, to distinguish between current and long-term liabilities, and to explain accrued liabilities. The student must also describe how liabilities are valued, explain why notes payable are usually reported first in the current liabilities, and to indicate the items that may comprise “compensation to employees.”

CA 13-2 (Time 15–20 minutes)

Purpose—to provide three situations that require the application of judgment about the current or long-term nature of the items. The student must think about when typical short-term items might not be classified as current.

CA 13-3 (Time 30–40 minutes)

Purpose—to provide the student with a comprehensive case covering refinancing of short-term debt. Four situations are presented in which the student must determine the proper classification and disclosure of the debt in the financial statements. In order to thoroughly resolve the issues presented, the student is expected to research **FASB Statement No. 6**.

CA 13-4 (Time 20–25 minutes)

Purpose—to provide an opportunity for the student to analyze a situation in which short-term debt is refinanced. The student must comment on the proper balance sheet classification for the debt at three different balance sheet dates. The student is also required to determine the proper balance sheet classifications if instead of actually refinancing the debt, a financing agreement had been initiated. A structural case which calls for the student to apply the principles related to refinancing of short-term debt.

CA 13-5 (Time 15–20 minutes)

Purpose—to provide the student with an opportunity to comment on the proper treatment in the financial statements of a contingent loss incurred after the balance sheet date but before issuance of the financial statements. In order to thoroughly answer the case the student will need to understand **FASB Statement No. 5**.

CA 13-6 (Time 15–20 minutes)

Purpose—to provide the student with an opportunity to specify the conditions by which a loss contingency can be recorded in the accounts. The student is also required to indicate the proper disclosure in the financial statements of the situations where the amount of loss cannot be reasonably estimated.

CA 13-7 (Time 15–20 minutes)

Purpose—the student discusses how product warranty costs and the fact that a company is being sued should be reported.

CA 13-8 (Time 20–25 minutes)

Purpose—the student is given the opportunity to examine the ethical issues related to estimates for bad debts and warranty obligations.

SOLUTIONS TO CONCEPTS FOR ANALYSIS

CA 13-1

- (a) A liability is defined as “probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.” In other words, it is an obligation to transfer some type of resource in the future as a result of a past transaction.
- (b) Current liabilities are “obligations whose liquidation is reasonably expected to require use of existing resources properly classified as current assets or the creation of other current liabilities.” In other words, they are liabilities generally payable within one year or the operating cycle, whichever is longer.
- (c) Accrued liabilities (sometimes called accrued expenses) arise through accounting recognition of unpaid expenses that come into existence as a result of past contractual commitments or past services received. Examples are wages payable, salaries payable, interest payable, property taxes payable, income tax payable, payroll taxes payable, bonus payable, postretirement benefits payable, and so on.
- (d) Theoretically, liabilities should be measured by the present value of the future outlay of cash required to liquidate them. But in practice, current liabilities are usually recorded in accounting records and reported in financial statements at their maturity value. Because of the short time periods involved—frequently less than one year—the difference between the present value of a current liability and the maturity value is not large. The slight overstatement of liabilities that results from carrying current liabilities at maturity value is accepted on the grounds it is immaterial.
- (e) Notes payable are listed first in the balance sheet because in liquidation they would probably be paid first.
- (f) The item compensation to employees might include:
 - 1. Wages, salaries, or bonuses payable.
 - 2. Compensated absences payable.
 - 3. Postretirement benefits payable.

CA 13-2

- 1. Since the notes payable are due in less than one year from the balance sheet date, they would generally be reported as a current liability. The only situation in which this short-term obligation could possibly be excluded from current liabilities is if D’Annunzio Corp. intends to refinance it. For those notes to qualify for exclusion from current liabilities, the company must meet the following criteria:
 - (1) It must intend to refinance the obligation on a long-term basis, and
 - (2) It must demonstrate an ability to consummate the refinancing.

The second criteria, ability to refinance, can be demonstrated either by actually refinancing before the balance sheet is issued or by entering into a noncancelable financing agreement, which has not been violated, with a capable lender. Only that portion of the \$25,000,000 which has been refinanced can be reclassified.

CA 13-2 (Continued)

2. Generally, deposits from customers would be classified as a current liability. However, the classification of deposits as current or noncurrent depends on the time involved between the date of deposit and the termination of the relationship that required the deposit. In this case, the \$6,250,000 would be excluded from current liabilities only if the equipment would not be delivered for more than one year (or one operating cycle, if longer).
3. Salaries payable is an accrued liability which in almost all circumstances would be reported as a current liability (could not be excluded).

CA 13-3

(This case requires some research of **FASB Statement No. 6**.)

- (a) No. **FASB Statement No. 6**, paragraph 2, states that refinancing a short-term obligation on a long-term basis means either replacing it with a long-term obligation or with equity securities, or renewing, extending, or replacing it with short-term obligations for an uninterrupted period extending beyond one year (or the operating cycle, if applicable) from the date of an enterprise's balance sheet.

Management's intent to refinance the obligation on a long-term basis is not enough to warrant reclassification of the short-term obligation. **FASB Statement No. 6**, paragraph 11, indicates that the enterprise's intent must be supported by an ability to consummate the refinancing demonstrated in a way specified in paragraph 11 of the Statement.

- (b) Yes. The events described will have an impact on the financial statements. Since Eshkol Corporation refinanced the long-term debt maturing in March 2008 in a manner that meets the conditions set forth in **FASB Statement No. 6**, paragraphs 10 and 11, that obligation should be excluded from current liabilities. The \$11,000,000 should be classified as long-term at December 31, 2007.

A short-term obligation, other than one classified as a current liability in paragraph 8 of the Statement, shall be excluded from current liabilities if the enterprise's intent to refinance the short-term obligation on a long-term basis is supported by an ability to consummate the refinancing demonstrated in one of the ways stipulated in paragraph 11 of the Statement. One of the ways stipulated is the issuance of long-term debt or equity securities after the date of the balance sheet but before that balance sheet is issued. The issuance of the long-term debt or equity securities must be for the purpose of refinancing the short-term obligation on a long-term basis.

- (c) No. since Eshkol Corporation refinanced the long-term debt maturing in March 2008 in a manner that meets the conditions set forth in **FASB Statement No. 6**, paragraphs 10 and 11, that obligation should be excluded from current liabilities.
- (d)
 - (1) No. The \$11,000,000 should be shown under the caption of either "Long-Term Debt," "Interim Debt," "Short-Term Debt Expected to Be Refinanced," or "Intermediate Debt."
 - (2) Yes. Paragraph 15 of the Statement provides that total current liabilities shall be presented in classified balance sheets. If a short-term obligation is excluded from current liabilities pursuant to the provisions of this statement, the notes to the financial statements shall include a general description of the financing agreement and the terms of any new obligation incurred or expected to be incurred or equity securities issued or expected to be issued as a result of a refinancing.

CA 13-4

- (a) The \$4,000,000 of commercial paper liquidated in January would be classified as a current liability in the corporation's balance sheet at December 31, 2006. Since the \$4,000,000 of commercial paper is liquidated in January 2007, this amount would not appear on either the January 31, 2007 or February 28, 2007 balance sheets. The \$6,000,000 of commercial paper liquidated in March 2007 but refinanced by the long-term debt offering in February 2007 would be excluded from current liabilities in the balance sheets at the end of December 2006, January 2007, and February 2007; this \$6,000,000 would be classified as long-term debt. At the end of February 2007, \$6,000,000 of cash would be excluded from current assets or if included in current assets, a like amount of debt would be classified as a current liability.

The position of the FASB in **Interpretation No. 8** is that if a short-term obligation is repaid after the balance sheet date and subsequently long-term debt is issued, whose proceeds are used to replenish current assets before the balance sheet is issued, the short-term obligation should be included in current liabilities.

- (b) The classifications are the same as in part (a). The intent to refinance accompanied with a financing agreement is considered equivalent to an actual refinancing for purposes of classifying the short-term obligation.

CA 13-5

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

If the loss to assets or the liability incurrence can be reasonably estimated, disclosure may best be made by supplementing the historical financial statements with pro forma financial data giving effect to the loss as if it had occurred at the date of the financial statements (see paragraph 11 of **FASB Statement No. 5**).

CA 13-6

- (a) Two conditions must exist before a loss contingency is recorded:
1. Information available prior to the issuance of the financial statements indicates that it is probable that a liability has been incurred at the date of the financial statements.
 2. The amount of the loss can be reasonably estimated.
- (b) When some amount within the range appears at the time to be a better estimate than any other amount within the range, that amount is accrued. When no amount within the range is a better estimate than any other amount, the dollar amount at the low end of the range is accrued and the dollar amount at the high end of the range is disclosed.
- (c) If the amount of the loss is uncertain, the following disclosure in the notes is required:
1. The nature of the contingency.
 2. An estimate of the possible loss or range of loss or a statement that an estimate cannot be made.

CA 13-7

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

1. It is probable that a liability has been incurred based on past experience.
2. The amount of the loss can be reasonably estimated as 1% of sales. Thus the matching principle is being followed.

For Product Henrick, the estimated product warranty costs should not be accrued by a charge to income because the amount of loss cannot be reasonably estimated. Since only one condition is satisfied, a disclosure by means of a note should be made.

Part II. The probable judgment (\$800,000) should be accrued by a charge to expense and a credit to a liability because both of the following conditions were met.

1. It is probable that a liability has been incurred because Toni Morrison's lawyer states that it is probable that Toni Morrison will lose the suit.
2. The amount of loss can be reasonably estimated because Toni Morrison's lawyer states that the most probable judgment is \$800,000.

Thus, the principle of conservatism is being followed.

Toni Morrison should disclose in its financial statements or notes the following:

The amount of the suit (\$4,000,000).

The nature of the accrual.

The nature of the contingency.

The range of possible loss (\$400,000 to \$2,000,000).

CA 13-8

- (a) No, Callaway should not follow his owner's directive if his (Callaway's) original estimates are reasonable.
- (b) Blue Clothing Store benefits in lower rental expense. The Elwood Company is harmed because the misleading financial statement deprives it of its rightful rental fees. In addition, the current stockholders of Blue Clothing Store are harmed because the lower net income reduces the current value of their holdings.
- (c) Blue is acting unethically to avoid the terms of his rental agreement at the expense of his landlord and his own stockholders.

FINANCIAL REPORTING PROBLEM

- (a) P&G's short-term borrowings were \$8,287 million at June 30, 2004.

SHORT-TERM DEBT

(In millions)	2004
U.S. dollar commercial paper	\$ 6,059
Non-U.S. dollar commercial paper	149
Current portion of long-term debt	1,518
Other	<u>561</u>
Total short-term debt	<u>\$ 8,287</u>

The weighted average interest rate is 1.5%.

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

$$(\$5,032,000,000) = (\$17,115,000,000 - \$22,147,000,000)$$

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

$$.45 \text{ times} = \frac{\$5,469,000,000 + \$423,000,000 + \$4,062,000}{\$22,147,000,000}$$

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

$$.77 \text{ times} = \frac{17,115,000,000}{22,147,000,000}$$

While P&G's current and acid-test ratios are below one, this may not indicate a weak liquidity position. Many large companies carry relatively high levels of accounts payable, which charge no interest. For example, P&G has approximately \$11,000 million of these short term obligations, which can be viewed as very cheap forms of financing. Nonetheless, its short term debt (see part (a)) has increased significantly (from \$2,172 million to \$8,287 million) in 2004, which raises some liquidity/working capital concerns.

FINANCIAL REPORTING PROBLEM (Continued)

- (c) **P&G provided the following discussion related to commitments and contingencies:**

Note 11: Commitments and Contingencies

Guarantees

In conjunction with certain transactions, primarily divestitures, the Company may provide routine indemnifications (e.g., retention of previously existing environmental, tax and employee liabilities) whose terms range in duration and often are not explicitly defined. Generally, the maximum obligation under such indemnifications is not explicitly stated and, as a result, the overall amount of these obligations cannot be reasonably estimated. Other than obligations recorded as liabilities at the time of divestiture, historically the Company has not made significant payments for these indemnifications. The company believes that if it were to incur a loss in any of these matters, the loss would not have a material effect on the Company's financial condition or results of operations.

In certain situation, the Company guarantees loans for suppliers and customers. The total amount of guarantees issued under such arrangements is not material.

Off-Balance Sheet Arrangements

The Company does not have off-balance sheet financing arrangements, including variable interest entities, under FASB interpretation No. 46, "Consolidation of Variable interest Entities," that have a material impact on the financial statements.

Purchase Commitments

The Company has purchase commitments for materials, supplies, services and property, plant and equipment as part of the normal course of business. Due to the proprietary nature of many of the Company's materials and processes, certain supply contracts contain penalty provisions for early termination. The Company does not expect potential payments under these provisions to materially affect results of operations or its financial condition in any individual year.

FINANCIAL REPORTING PROBLEM (Continued)

Operating Leases

The Company leases certain property and equipment for varying periods under operating leases. Future minimum rental commitments under noncancellable operating leases are as follows: 2005 - \$186; 2006 - \$150; 2007 - \$134; 2008 - \$99; 2009 - \$86; and \$265 thereafter.

Litigation

The Company is subject to various lawsuits and claims with respect to matters such as governmental regulations, income taxes and other actions arising out of the normal course of business. The Company is also subject to contingencies pursuant to environmental laws and regulations that in the future may require the Company to take action to correct the effects on the environment of prior manufacturing and waste disposal practices. Accrued environmental liabilities for remediation and closure costs were \$36 and \$34 at June 30, 2004 and 2003, respectively. Current year expenditures were not material.

While considerable uncertainty exists, in the opinion of management and Company counsel, the ultimate liabilities resulting from such lawsuits and claims will not materially affect the Company's financial condition.

FINANCIAL STATEMENT ANALYSIS CASE 1

NORTHLAND CRANBERRIES

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

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

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

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

FINANCIAL STATEMENT ANALYSIS CASE 2

MOHICAN COMPANY

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

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

- (b) When the warranty is sold separately from the product, the sales warranty approach is employed. Revenue on the sale of the extended warranty is deferred and is generally recognized on a straight-line basis over the life of the contract. Revenue is deferred because the seller of the warranty has an obligation to perform services over the life of the contract.
- (c) The general approach is to use the straight-line method. If historical evidence indicates that costs incurred do not follow a straight-line approach, then revenue should be recognized over the contract period in proportion to the costs expected to be incurred in performing services under the contract. Only costs that vary with and are directly related to the acquisition of the contracts (mainly commissions) should be deferred and amortized. Costs such as employee's salaries, advertising, and general and administrative expenses that would have been incurred even if no contract were acquired should be expensed as incurred.

COMPARATIVE ANALYSIS CASE

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

PepsiCo, Inc.

Current assets	\$ 8,639,000,000
Current liabilities	<u>6,752,000,000</u>
Working capital	<u>\$ 1,887,000,000</u>

The Coca-Cola Company

Current assets	\$ 12,094,000,000
Current liabilities	<u>10,971,000,000</u>
Working capital	<u>\$ 1,123,000,000</u>

COMPARATIVE ANALYSIS CASE (Continued)

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

(all computations in millions)

	PepsiCo, Inc.	Coca-Cola
Current cash debt coverage ratio	$\frac{\$5,054}{\$6,415 + \$6,752} = .77$	$\frac{\$5,968}{\$7,886 + \$10,971} = .63$
	2	2

(all computations in millions)

	PepsiCo, Inc.	Coca-Cola
Cash debt coverage ratio	$\frac{\$5,054}{\$13,453 + \$14,464} = .36$	$\frac{\$5,968}{\$13,252 + \$15,392} = .42$
	2	2

Current ratio	$\frac{\$8,639}{\$6,752} = 1.28$	$\frac{\$12,094}{\$10,971} = 1.10$
---------------	----------------------------------	------------------------------------

Acid-test ratio	$\frac{\$1,280 + \$2,165 + \$2,999}{\$6,752} = .95$	$\frac{\$6,707 + \$61 + \$2,171}{\$10,971} = .81$
-----------------	---	---

Receivables turnover	$\frac{\$29,261}{\$2,830 + \$2,999} = 10.04$	$\frac{\$21,962}{\$2,091 + \$2,171} = 10.31$
	2	2

Inventory turnover	$\frac{\$13,406}{\$1,412 + \$1,541} = 9.1$	$\frac{\$7,638}{\$1,252 + \$1,420} = 5.7$
	2	2

COMPARATIVE ANALYSIS CASE (Continued)

(c) As indicated in the chapter, a company can exclude a short-term obligation from current liabilities only if both of the following conditions are met:

- 1. It must intend to refinance the obligation on a long-term basis, and**
- 2. It must demonstrate an ability to consummate the refinancing.**

At year-end 2004, \$750 million of short-term borrowings were classified as long-term debt, reflecting PepsiCo's intent and ability, through the existence of the unused credit facilities, to refinance these borrowings. These credit facilities exist largely to support the issuance of short-term borrowings and are available for acquisitions and other general purposes.

PepsiCo uses variable interest rate debt for 67% of total debt. Note that PepsiCo is using interest rate swaps to convert fixed rate debt to variable and vice-versa.

(d) Coca-Cola discusses its contingencies in the following note:

NOTE 11: COMMITMENTS AND CONTINGENCIES

On December 31, 2004, we were contingently liable for guarantees of indebtedness owned by third parties in the amount of \$257 million. None of these guarantees is individually significant. We do not consider it probable that we will be required to satisfy these guarantees.

In December 2003, we granted a \$250 million standby line of credit to Coca-Cola FEMSA with normal market terms. As of December 31, 2004 and 2003, no amounts have been drawn against this line of credit.

We believe our exposure to concentrations of credit risk is limited due to the diverse geographic areas covered by our operations.

COMPARATIVE ANALYSIS CASE (Continued)

The Company is involved in various legal proceedings. Management believes that any liability to the Company that may arise as a result of currently pending legal proceedings will not have a material adverse effect on the financial condition of the Company taken as a whole.

PepsiCo Co. discusses its contingencies in the following note:

NOTE 2: COMMITMENTS AND CONTINGENCIES

We are subject to various claims and contingencies related to lawsuits, taxes and environmental matters, as well as commitments under contractual and other commercial obligations. We recognize liabilities for contingencies and commitments when a loss is probable and estimable. For additional information on our commitments, see Note 9.

Note 9—Debt Obligations and Commitments

	<u>2004</u>	<u>2003</u>
<u>Short-term debt obligations</u>		
Current maturities of long-term debt	\$ 160	\$ 446
Other borrowings (3.2% and 5.1%)	1,644	520
Amounts reclassified to long-term debt	<u>(750)</u>	<u>(375)</u>
	<u>\$1,054</u>	<u>\$ 591</u>
<u>Long-term debt obligations</u>		
Short-term borrowings, reclassified	\$ 750	\$ 375
Notes due 2005–2026 (4.7% and 5.7%)	1,274	1,186
Zero coupon notes, \$575 million due 2005–2012 (13.4%)	321	330
Other, due 2005–2014 (6.2% and 6.4%)	<u>212</u>	<u>257</u>
	2,557	2,148
Less: current maturities of long-term debt obligations	<u>(160)</u>	<u>(446)</u>
	<u>\$2,397</u>	<u>\$1,702</u>

COMPARATIVE ANALYSIS CASE (Continued)

The interest rates in the above table reflect weighted-average rates as of year-end.

Short-term borrowings are reclassified to long-term when we have the intent and ability, through the existence of the unused lines of credit, to refinance these borrowings on a long-term basis. At year-end 2004, we maintained \$1.5 billion in corporate lines of credit subject to normal banking terms and conditions. These credit facilities support short-term debt issuances and remained unused as of December 25, 2004. Of the \$1.5 billion, \$750 million expires in June 2005 with the remaining \$750 million expiring in June 2009. Upon consent of PepsiCo and the lenders, these facilities can be extended an additional year. In addition, \$267 million of our debt was outstanding on various lines of credit maintained for our international divisions. These lines of credit are subject to normal banking terms and conditions and are committed to the extent of our borrowings.

RESEARCH CASE 1

- (a) Of the 794 gain contingencies identified in the 2004 edition of *Accounting Trends and Techniques*, 416 are related to operating loss carry forwards, 247 are related to tax credits, 18 are investment credit carry forwards, 37 pertain to plaintiff litigation, 66 are due to capital loss carry forwards, and 10 to other gain contingencies.**
- (b) One of the two gain litigation-related footnotes include dollar amounts. The contingent receivable note included dollar amounts.**
- (c) The amounts disclosed range from approximately \$34 million to \$470 million.**

RESEARCH CASE 2

(a) According to *SFAS No. 5*, recognition of a loss contingency, (which is what these anticipated claims represent), is required if both of the following conditions are met:

- (a) It is probable that a liability has been incurred, and
- (b) The amount of the loss can be reasonably estimated.

It appears in the article that both of these conditions are met. Georgia Pacific already has a number of lawsuits filed against it related to its gypsum products made from 1965–1977. In addition, Georgia Pacific has hired a research firm to help it arrive at a reasonable estimate for the amount of its potential obligations.

(b) Loss from Estimated Asbestos Claims.....	221,000,000
Liability for Asbestos Claims.....	221,000,000

The loss would be reported as a loss (not extraordinary) in the income statement. The liability would appear in Georgia Pacific's balance sheet, probably as long term. Note disclosure would explain the nature of the contingency and how the obligation was estimated.

(c) Georgia Pacific hired economic consultants to help them develop estimates of their asbestos obligation. Presumably, these consultants have experience in other cases involving settlements of claims related to asbestos injuries. With enough prior data concerning settlement of asbestos cases, the consultants would be able to arrive at a reliable estimate for Georgia Pacific's asbestos obligation.

RESEARCH CASE 3

- (a) BOP's working capital and current ratio have declined in 2007 compared to 2006. While this would appear to be bad news, the acid test ratio has improved. This is due to BOP carrying relatively more liquid receivables in 2007 (receivable days has increased.) And while working capital has declined, the amount of the operating cycle that must be financed with more costly borrowing has declined. That is, BOP is using relatively inexpensive accounts payable to finance its operating cycle. Note that the overall operating cycle has declined because inventory is being managed at a lower level (inventory days has declined by more than 60 days).
- (b) Answers will vary depending on the companies selected. This activity is a great spreadsheet exercise. The analysis for Best Buy and Circuit City is presented below.

	Best Buy (in millions)			Circuit City		
	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>
Cash	\$ 1,914	\$ 245	\$ 470	884,670	783,471	879,660
Accounts Receivable	312	343	375	215,125	170,568	172,995
Inventory	2,077	2,607	2,851	1,409,736	1,517,256	1,459,520
Accounts Payable	2,195	2,460	2,824	963,701	833,825	961,718
Purchases	16,200	19,207	21,227	7,823,485	7,680,569	7,845,905
Cost of Goods Sold	15,998	18,677	20,938	7,647,992	7,573,049	7,903,641
Sales		24,548	27,433		9,857,057	10,472,364
 <u>Operating Cycle</u>						
Receivable Days		5.1	5.0		6.3	6.0
Inventory Days		<u>50.9</u>	<u>49.7</u>		<u>73.1</u>	<u>67.4</u>
Operating Cycle		56.0	54.7		79.4	73.4
 <u>Less: Accounts</u>						
Payable Days		<u>46.75</u>	<u>48.56</u>		<u>39.63</u>	<u>44.74</u>
Days to be Financed		<u>9.25</u>	<u>6.14</u>		<u>39.77</u>	<u>28.66</u>
 <u>Working Capital</u>						
Working Capital		\$735	\$872	\$1,637,470	\$1,550,457	
Current Ratio		1.30	1.31	2.96	2.61	
Acid Test Ratio		0.24	0.30	1.14	1.09	

Best Buy reports both a lower current ratio and acid-test ratio. However, much more of Best Buy's operating cycle is financed with relatively inexpensive accounts payable.

Search Strings: separately priced contract, “incremental direct acquisition costs,” warranty sold separately

- (a) FTB90-1, Par. 1. This technical bulletin addresses how revenue and costs from a separately priced extended warranty or product maintenance contract should be recognized?
- (b) FTB90-1, Par. 2. An extended warranty is an agreement to provide warranty protection in addition to the scope of coverage of the manufacturer’s original warranty, if any, or to extend the period of coverage provided by the manufacturer’s original warranty. A product maintenance contract is an agreement to perform certain agreed-upon services to maintain a product for a specified period of time. The terms of the contract may take different forms, such as an agreement to periodically perform a particular service a specified number of times over a specified period of time, or an agreement to perform a particular service as the need arises over the term of the contract. Some contracts may provide both extended warranty coverage and product maintenance services. A contract is separately priced if the customer has the option to purchase the services provided under the contract for an expressly stated amount separate from the price of the product.
- (c) FTB90-1, Par. 4. Costs that are directly related to the acquisition of a contract and that would have not been incurred but for the acquisition of that contract (incremental direct acquisition costs) should be deferred and charged to expense in proportion to the revenue recognized. All other costs, such as costs of services performed under the contract, general and administrative expenses, advertising expenses, and costs associated with the negotiation of a contract that is not consummated, should be charged to expense as incurred.
- (d) FTB90-1, Par. 14. A proposed Technical Bulletin, Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts, was released for comment on August 15, 1990. Fifty-two letters of comment were received on the proposed Technical Bulletin. Certain of the comments received and consideration of them are discussed in the following paragraphs.

FTB90-1, Par. 22. Some respondents commented that the effective date of this Technical Bulletin should be delayed. Many of the retail entities affected by this Technical Bulletin have fiscal years that end in the first calendar quarter. The effective date was changed to contracts sold in fiscal years beginning after December 15, 1990 so those entities would not be required to adopt the provisions of this Technical Bulletin for the last few months of their current fiscal years. Others commented that entities should be permitted to change their method of accounting for the contracts by reporting the cumulative effect of an accounting change. This Technical Bulletin was revised to allow this option by application of APB Opinion 20.

PROFESSIONAL SIMULATION

Journal Entries

(a)	Unearned Subscriptions Revenue	400,000	
	Subscriptions Revenue		400,000
	(To record subscriptions earned during 2006)		
	Book balance of liability account at		
	December 31, 2006		\$2,300,000
	Adjusted balance (\$600,000 + \$500,000		
	+ \$800,000)		<u>1,900,000</u>
	Credit to revenue account.....		<u>\$ 400,000</u>

(b) No entry should be made to accrue for an expense, because the absence of insurance coverage does not mean that an asset has been impaired or a liability has been incurred as of the 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.

(c)	Loss from Pending Lawsuit.....	300,000	
	Liability from Pending Lawsuit.....		300,000
	(To record estimated minimum damages on breach-of-contract litigation)		

PROFESSIONAL SIMULATION (Continued)

Explanation

If a liability is scheduled to mature within one year after the date of an enterprise's balance sheet or within an operating cycle that is longer than one year, then the liability is classified as current (unless the liability will be retired using a noncurrent asset or a long-term debt). Current liabilities will be liquidated (retired, discharged, paid) by the use of a resource properly classified as a current asset or by the creation of another current liability. Obligations are classified as noncurrent liabilities when they mature beyond one year or the operating cycle (whichever is longer) or if they are to be retired, discharged, or paid by using noncurrent assets.

Generally all three of these liabilities (accounts payable, notes payable, bonds payable) would be classified as current liabilities on the company's balance sheet prepared as of December 31, 2006.

However, the bonds payable, and possibly the notes payable, could be classified as noncurrent liabilities if the company intends to refinance the obligations on a long-term basis and the company's intent to refinance the current obligations on a long-term basis can be demonstrated by: (1) issuance of long-term obligations or equity securities after the balance sheet date but before issuance of the financial statements and before the maturity date of the debt; or (2) by entering into a financing agreement before the balance sheet is issued and before the maturity date of the debt. The financing agreement should outline the terms of refinancing the current obligations on a long-term basis. Alternatively, the bonds and notes could be classified as noncurrent if they are to be retired, discharged, or paid using noncurrent assets.