Financial Reporting: Valuation of Liabilities and Investments

CHAPTER 13
Current Liabilities and Contingencies

CHAPTER 14
Long-Term Liabilities and Receivables

CHAPTER 15
Investments
Current Liabilities and Contingencies

All I Want for Christmas

What do you get the person who has everything? For more and more consumers, the answer to this question is a gift card. According to a survey conducted by the National Retail Federation, consumers spent approximately $17.34 billion on gift cards during the 2004 holiday season. What does this mean for retailers? Many view the gift card as having significant benefits for the bottom line. Research shows that when gift cards are redeemed, as many as 60% of consumers will spend considerably more than the card’s face value. In addition, gift card advocates claim benefits in the form of reduced returns, lower processing and administrative costs relative to paper gift certificates, and increased value due to unredeemed gift cards (termed breakage revenue, the average consumer is estimated to leave as much as 15% of a gift card’s value unredeemed).

However, gift cards also present a hidden danger. While companies receive cash when the gift card is sold, the company must record a current liability, and delay the recognition of revenue,
until the card is redeemed. Therefore, “holiday” sales may not actually appear until months later. As reported in a January 11, 2005 press release, **Williams-Sonoma Inc.** noted that the disappointing sales for the eight-week period ending December 26, 2004 were due, in part, to significant increases in gift card sales, which caused retail sales to be shifted into a later reporting period. Furthermore, if gift card redemptions coincide with markdowns (e.g., after-Christmas sales), retailers may also see reductions in their gross margins.

**FOR FURTHER INVESTIGATION**

For a discussion of gift cards, consult the Business & Company Resource Center (BCRC):

This is the first of two chapters on liabilities. In Chapter 13 we focus on current liabilities (including contingencies). In Chapter 14 we discuss long-term (noncurrent) liabilities. The topics in both chapters depend on an understanding of the term liabilities. Our initial discussion expands on the concept and definition of a liability we presented in the review of the balance sheet in Chapter 4. We discuss the nature, definition, and valuation of current liabilities, and explain the items in three major groups of current liabilities. Then we examine the important issue of contingencies, after which we discuss short-term debt expected to be refinanced and obligations that are callable by the creditor. Last, we discuss specific methods of reporting current liabilities on the balance sheet and in the notes to the financial statements.

**Conceptual Overview of Liabilities**

In its *Conceptual Framework*, the FASB defines liabilities as follows:

> Liabilities are the probable future sacrifices of economic benefits arising from present obligations of a company to transfer assets or provide services in the future as a result of past transactions or events.¹

The FASB also explained two of the terms. The word **probable** refers to what can be expected or believed based on available evidence or logic. The word **obligations** refers to duties imposed legally or socially which one is bound to do by contract, promise, or moral responsibility. In other words, liabilities include both legal and nonlegal (but not illegal) obligations. **Legal liabilities** are incurred in transactions that are contractual—based on written or oral agreements to pay cash or to provide goods or services to other entities in the future. Legal liabilities include such items as accounts payable, notes payable, and sales tax payable. The **nonlegal group** (also called accounting liabilities) includes those obligations where there is no legal requirement for assets to be transferred, but a transfer of assets typically occurs as a part of the normal operations of a business.² Nonlegal liabilities include equitable and constructive obligations, such as the liability to employees for vacation pay or year-end bonuses. These are obligations that a company accepts by paying them every year even though it is not contractually required and has not announced a policy to do so. We discuss the accounting for both types of liabilities later in this chapter.

As we introduced in Chapter 3, there are **three characteristics of a liability** for a company:

1. A liability involves a responsibility that will be settled by the probable future transfer or use of assets at a specified or determinable date, on occurrence of a specific event, or on demand.
2. The responsibility obligates the company so that it has little or no discretion to avoid the future sacrifice.
3. The transaction or other event obliging the company has already happened.

The main features of these three characteristics are highlighted by italics: the requirement that a company transfer or use assets, that the obligation cannot be avoided, and that the liability transaction has already occurred.

There are two additional factors involving a liability. First, the company does not need to know the identity of the recipient before the time of settlement. Second, a legally enforceable claim is not a prerequisite for an obligation to qualify as a liability.³ Note,

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however, that some liabilities are “liquidated” by conversion into common or preferred stock or by refinancing into other liabilities, as we discuss in Chapter 14.

The financial accounting issues related to liabilities are important in both balance sheet valuation and income statement measurement. The primary issues discussed in the remainder of this chapter are:

- **Identification** of liabilities—the detection of a company’s obligations
- **Valuation** of the liabilities and measurement of the related expense—the determination of an amount to record for each obligation and to match as an expense against revenues
- **Reporting** on the financial statements—the specific disclosures in both the company’s financial statements and the related notes

Liabilities generally are classified as either current or long-term. We discuss the preceding issues in this chapter as they relate to current liabilities.

### NATURE AND DEFINITION OF CURRENT LIABILITIES

The specific meaning, nature, and classification of current liabilities are important to users of financial statements.

#### Classification and the Operating Cycle or Year

Recall that current liabilities are obligations of a company that it expects to liquidate by using existing current assets or creating other current liabilities within one year or the normal operating cycle, whichever is longer. The usual criterion is one year. For certain companies, however, where the operating cycle—from cash to inventory to receivables and back to cash—is longer than a year, the length of the operating cycle determines the classification of the liability. Many current liabilities, such as accounts payable, wages payable, warranty obligations, and notes payable, are incurred (and paid) during the operating cycle. For example, a current liability—Accounts Payable—is created when an inventory item is acquired. Also, a current liability, Salaries Payable, arises as a result of accrued salaries for sales, as well as general and administrative, personnel.

Some users question using different time periods for classifying liabilities as current. They prefer to use the length of the operating cycle as the period for classifying liabilities, regardless of whether it is longer or shorter than a year. Since this issue deals primarily with the question of liquidity, we discuss liquidity and the related issue of financial flexibility next.

#### Liquidity, Financial Flexibility, and Current Liabilities

One attribute of a liability (and also an asset) is its liquidity. **Liquidity refers to how quickly a company can convert its assets to cash to pay its liabilities.** One aspect of a company’s liquidity is how soon its bills (liabilities) must be paid. The FASB is concerned about reporting the liquidity of liabilities and assets because users evaluate future cash flows in their decision-making processes. In part, these future cash flows are predicted based on the nearness to cash of liabilities and assets. Therefore, knowledge of the liquidity of liabilities and assets is important in these decision-making processes. The Board studied ways of relating liabilities and assets to each other and to other financial statement data to obtain information about a company’s liquidity. It listed five “liquidity” ratios as providing information to lending institutions, creditors, and other external users of financial information: (1) cash flows to total debt, (2) net income to total assets (return on total assets ratio), (3) total debt to total assets (debt ratio), (4) current assets to current liabilities

(current ratio), and (5) cash to current liabilities. Four of the five require information about a company’s liabilities; two require information about its current liabilities. Since we discussed ratio analysis in detail in Chapter 6, we do not discuss these ratios here.

The AICPA Special Committee on Financial Reporting reinforced the Board’s view by stating that in a company’s MD&A, its management should identify and describe internal and external sources of liquidity, and significant unused sources of liquid assets. It also believes that a company should disclose the impact of “illiquidity” on financial flexibility. Financial flexibility refers to a company’s ability to use its financial resources to adapt to change. This ability primarily involves the management of cash and other resources to achieve certain financial advantages from both an offensive and defensive point of view. In part, it also involves the potential to create new current and long-term liabilities, to restructure existing debt, and to manage debt in other ways. We discuss these features relating to financial flexibility later in this chapter and in other chapters.

**Classification of Current Liabilities**

A company reports its current liabilities in the first section of its liabilities on its balance sheet. Many current liabilities are easily identifiable and have a “contractual” amount. Some current liabilities, though identifiable, have amounts that depend on operations. Others require that amounts be estimated. We classify the primary types of current liabilities in three groups, as we show in Exhibit 13-1, although some types might fit in more than one category. We organize our discussion according to these three types.

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VALUATION OF CURRENT LIABILITIES
Conceptually, a company should record (and report on its balance sheet) all its liabilities at the present value of the future payments they will require. In practice, however, most current liabilities are measured, recorded, and reported at their maturity or face amount. The difference between the maturity amount and the present value of the maturity amount is usually not material because of the short time period involved (usually one year or less). Although a slight overstatement of liabilities results from reporting current liabilities at their maturity amount, this overstatement is justified on the basis of cost/benefit and materiality constraints.

CURRENT LIABILITIES HAVING A CONTRACTUAL AMOUNT
The short-term liabilities in this group result from the terms of contracts or from the existence of laws. In these cases the debt and its maturity are known with reasonable certainty. The accounting issues we discuss in this section for each current liability are (1) identifying the item, (2) measuring it, and (3) recording it in the accounts.

Trade Accounts Payable
A company’s trade accounts payable arise from the purchase of inventory, supplies, or services on credit. The credit period generally varies from 30 to 120 days without any interest being charged. A company usually records the amount of the liability in its accounting system when it receives the invoice from the supplier.

Issues often arise when a company purchases inventory near the end of its accounting period. Goods may be shipped by the supplier and still be in transit at year-end, as
we discussed in Chapter 8. The purchaser should record both the purchase and the liability in the accounting period in which the economic control of the goods passes. For goods shipped FOB shipping point, economic control of (and legal title to) the goods passes to the purchaser at the supplier’s shipping point. For goods shipped FOB destination, economic control of (and legal title to) the goods is transferred to the purchaser when it receives the merchandise. The owner of the merchandise in transit usually pays the cost of the freight.

The amount of the trade accounts payable usually is easily determined by reviewing the invoice. An accounting issue arises when cash discount terms (for example, 2/10, n/30; or 3/10 EOM) are offered. A company should take advantage of all cash discounts because of the high effective interest rate involved. Theoretically, it should show inventory (purchases) and the associated liability (accounts payable) less the cash discount. As we discussed in Chapter 8, however, a company may record accounts payable in two different ways:

1. using the **gross price method**, that is, at the invoice price—the liability is stated at the maximum amount required to be paid, or
2. using the **net price method**, that is, at the invoice price less the cash discount—the liability is stated at its current cash equivalent amount.

Assuming the company has a policy of taking cash discounts, use of the gross price method overstates accounts payable (a valuation issue) at the end of the accounting period because the company expects to pay less than the gross amount. We recommend the net method. Use of the net price method more accurately measures accounts payable (and liquidity) because it shows the most likely amount that the company will pay. Also, the net price method highlights management inefficiency because purchases discounts lost are recorded when an invoice is paid after the cash discount period has expired. The gross price method is more widely used, however, because of its simplicity and the lack of materiality of the differences between the two methods. For an illustration of the two methods, refer to Chapter 8.

**Notes Payable**

A note payable is an unconditional written agreement to pay a sum of money to the bearer on a specific date. Notes payable may be either short term (discussed here) or long term (discussed in Chapter 14). Notes arise either out of a trade situation—the purchase of goods or services on credit—or the borrowing of money. The promissory note is the source document a company uses to determine and record the initial amount of the liability. However, interest is important in determining the value of the liability at a later date. The interest for a note payable may be stated or implied in different ways. One note may be **interest-bearing**, with the principal listed as the face value and the interest rate stated on the note, and with interest payable at maturity. Another note may be **non-interest-bearing** in which the note is stated at its maturity value that includes both the principal and interest to maturity. For a non-interest-bearing note, the note is discounted and the borrower receives less than the face value. The interest on this type of note is the amount of the discount.

**Issuance of an Interest-Bearing Trade Note for Merchandise**

For an interest-bearing note, the principal amount (face value) is the present value of the liability and is used to record the current liability. Interest expense then is recorded over the life of the note by applying the stated interest rate to the face value. For example, assume that Trishan Corporation uses a perpetual inventory system and purchases merchandise for $7,000 on September 1, 2007 by issuing a $7,000, 12%, 30-day note to the
supplier. The company records the issuance of the note and the payment of the principal and interest (assuming, for simplicity, a 360-day business year) on September 1, 2007 and October 1, 2007, respectively, as follows:

**September 1, 2007**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory</td>
<td>7,000</td>
</tr>
<tr>
<td>Notes Payable</td>
<td>7,000</td>
</tr>
</tbody>
</table>

**October 1, 2007**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest Expense ($7,000 × 0.12 × 30/360)</td>
<td>70</td>
</tr>
<tr>
<td>Notes Payable</td>
<td>7,000</td>
</tr>
<tr>
<td>Cash</td>
<td>7,070</td>
</tr>
</tbody>
</table>

If the note spans two fiscal periods, the company makes an adjusting entry at the end of the first fiscal period to accrue the interest expense and to report the amount as a current liability, Interest Payable.

**Issue of Non-Interest-Bearing Note to Borrow Money**

For a non-interest-bearing note, the face value (which includes the interest to maturity) and the discount (the interest to maturity) of the note are used to record the current liability. Interest expense is then recorded over the life of the note as an adjustment of this discounted amount. For example, assume that on December 1, 2007, the Trollingwood Corporation (which has a fiscal year ending December 31) borrows money at First National Bank by issuing a $10,000, 90-day, non-interest-bearing note that is discounted on a 12% basis. Trollingwood receives only $9,700 [$10,000 − ($10,000 × 0.12 × 3/12)]. It makes four journal entries to record the events related to this note. First, it records the proceeds of the note on December 1, 2007 as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>9,700</td>
</tr>
<tr>
<td>Discount on Notes Payable</td>
<td>300</td>
</tr>
<tr>
<td>Notes Payable</td>
<td>10,000</td>
</tr>
</tbody>
</table>

Observe that $10,000 is the maturity (face) value of the note, but the company records the liability at its present value. The company debits the $300 discount (the interest expense applicable to the entire term of the note) to Discount on Notes Payable, and shows this account on its balance sheet as a contra account to Notes Payable to report the net amount of the current liquidation value. Since the life of this note extends into 2008, the company makes a second journal entry on December 31, 2007 to record a portion of the discount (1/3 × $300) as interest expense for 2007 as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest Expense</td>
<td>100</td>
</tr>
<tr>
<td>Discount on Notes Payable</td>
<td>100</td>
</tr>
</tbody>
</table>

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6. Alternatively, the company could record the Notes Payable at the current value ($9,700), in which case it would show the maturity value parenthetically on the balance sheet. Then the company would make the Interest Expense adjusting entry credit directly to Notes Payable to increase it to the maturity value.

7. In this situation, for simplicity we use the “straight-line” method to allocate the interest expense. In Chapter 14, we use the more conceptually correct “effective interest” method to calculate interest expense for long-term notes.
Observe that the reduction in the Discount on Notes Payable account increases the current liability amount shown on the company's balance sheet. The company records the last two journal entries at maturity on March 1, 2008 as follows:

\[
\begin{align*}
\text{Interest Expense} & \quad 200 \\
\text{Discount on Notes Payable} & \quad 200 \\
\text{Notes Payable} & \quad 10,000 \\
\text{Cash} & \quad 10,000
\end{align*}
\]

After the company makes the journal entry adjusting Interest Expense, Discount on Notes Payable has a zero balance so that the carrying value of the current liability equals the maturity value of the note. The second journal entry records the payment of the maturity value, which includes the $9,700 borrowed, plus the $300 total interest recognized (i.e., the amount of the discount).

Analysis

In borrowing money, a manager must be aware of the effective interest rate, referred to as the annual percentage rate (or APR), for each source of credit. In the preceding case, the approximate effective annual interest on the cash actually borrowed is higher than the discount rate of 12%. It is 12.37% \([\frac{$300 \div \$9,700}{4 \text{ quarters}}]\). Federal laws require lenders to disclose the APR to borrowers.

Currently Maturing Portion of Long-Term Debt

As a general rule, a company classifies the currently maturing portion of long-term debt as a current liability to show the effect on its liquidity. Two different situations are involved here. First, any long-term debt requiring the use of current assets for its retirement will become a current liability on the balance sheet prepared immediately before the year of retirement. If a company has issued 20-year bonds and these are due on July 1, 2008, the company reports their total amount as a current liability on the balance sheet prepared as of December 31, 2007. The second situation involves the issuance of serial bonds—that is, bonds that are retired in periodic installments. (We discuss serial bonds in an Appendix to Chapter 14). For example, assume that on July 1, 2006, Redlow Corporation issues 9% serial bonds with a face value of $1 million. These bonds are to be retired in installments of $100,000, beginning on July 1, 2008 and for each year thereafter until all bonds are retired. The company's balance sheet prepared as of December 31, 2007 would show the currently maturing installment of $100,000 as a current liability and the $900,000 (the installments due after December 31, 2008) as a long-term liability item. The current portion of other long-term debt (such as the current amount of lease obligations and certain deferred taxes) is treated in the same manner. These items, however, are not included in current liabilities if they will be refinanced on a long-term basis, as we discuss later in this chapter.

Dividends Payable

A company may declare (on the dividend declaration date by the board of directors) a cash dividend, a property dividend (a dividend payable in property other than cash), or a scrip dividend (a dividend that creates a promissory note). When a company declares a dividend, it reduces retained earnings and recognizes a current liability if it expects to distribute the dividend in the coming year or operating cycle. These dividends are recorded and reported at the amount to be paid. The liability is titled Dividends Payable, Property Dividends Payable, or Dividends Payable in Scrip. For

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8. An alternative approach involves debiting the original discount amount first to Interest Expense. Then, at the end of the period, an adjusting entry would be necessary to transfer the unexpired portion of the expense to the Discount on Notes Payable account. The Discount on Notes Payable account would be shown on the balance sheet as a contra account to Notes Payable, as we discussed earlier.
instance, if Brown Corporation declared a $50,000 cash dividend, on the date of declaration it would record the dividend as follows:

\[
\begin{align*}
\text{Retained Earnings} & \quad 50,000 \\
\text{Dividends Payable} & \quad 50,000
\end{align*}
\]

Note that accounting for the declaration of a dividend results in a shift of a stockholders’ equity element—retained earnings—to a current liability element. The company eliminates the liability on the date of payment. We discuss dividends in Chapter 17.

There are two exceptions to the recording of current liabilities for dividends. First, a company does not report a stock dividend to be issued as a current liability. Since a corporation distributes a stock dividend by issuing its own stock, it reports a stock dividend declared as an element of stockholders’ equity. Second, a company does not report undeclared dividends in arrears on cumulative preferred stock (which we discuss in Chapter 16) as liabilities until they are formally declared by the corporation’s board of directors. However, it discloses them in the notes to the financial statements because they potentially affect its future liquidity.

**Advances and Refundable Deposits**

Many utility and other companies require customers and employees to make deposits. These deposits may be required as guarantees to cover equipment used by the customer, to cover payments that may arise in the future, or to guarantee performance of a contract or service. Since these deposits either are refundable or are later offset against a trade receivable, they are a special type of liability. Accounting for these deposits involves an increase in a liability describing the nature of the refundable deposit. For example, the liability for a refundable deposit received by a utility company may be called Refundable Deposits Received from Customers. The law frequently requires that interest be paid on these deposits. Therefore, most utility companies refund the deposit as soon as a customer has established a good credit standing. The utility company must accrue any related interest expense and report the amount as a current liability, Interest Payable.

**Accrued Liabilities**

Accrued liabilities are obligations that accumulate in a systematic way over time. For convenience, a company usually waits until the end of the accounting period to make adjusting entries to record these liabilities and the related expenses. Most accrued liabilities are current liabilities. Some are definite in amount, while the amounts of others are based on operations or estimates.

**Accrued Liability for Compensated Absences**

FASB Statement No. 43 defines the accounting for compensated absences. **Compensated absences include vacation, holiday, illness, or other personal activities for which a company pays its employees.** They do not include items such as severance pay, stock options, or long-term fringe benefits. A company recognizes an expense and accrues a liability for employees’ compensation for future absences if all the following conditions are met:

1. The company’s obligation relating to the employee’s rights to receive compensation for future absences is based on the employee’s services already rendered;
2. The obligation relates to rights that vest or accumulate;
3. Payment of the compensation is probable; and
4. The amount can be reasonably estimated.9

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If the company meets the first three conditions but does not accrue a liability because the last condition is not met, it discloses the known facts about these compensated absences in the notes to its financial statements.

Two terms need more explanation. A **vested right** exists when an employer has an obligation to make payment to an employee that is not contingent on the employee’s future services. An **accumulated right** is one that can be carried forward by the employee to future periods if the employee does not take them in the period in which they are earned. The most common type is **vacation time** that is allowed to accumulate and for which payment is probable. Even if these rights do not vest, they accumulate and the employer must recognize an expense and accrue a current liability. In doing so, it allows for those rights it does not expect employees to exercise.

The second most frequent compensated absence is **sick pay**, which is treated by FASB Statement No. 43 differently from vacation pay. If sick pay benefits **vest** and are not used by the end of the period, then the employer must recognize an expense and accrue a current liability. If sick pay benefits **accumulate** but do not vest, recognition and accrual is optional. The reason for this exception to the general recognition rule is that employers administer sick pay in at least two different ways. Some companies permit employees to accumulate unused sick pay and take compensated time off from work even though they are not ill. A company must accrue a current liability for this type of sick pay because it is probable that it will be paid in the future, regardless of whether or not the employees are ill. Other companies require that employees receive accumulated sick pay only if they are absent from work because of illness. In this case, accrual is optional because payment is less likely and measurement of the amount is less reliable.

There is a **conceptual difference** between vacation pay and sick pay. **Vacation pay is earned as a result of past employment** (the services rendered by the employee), whereas **sick pay is earned only when the future event (sickness) occurs**. In the latter case, the criteria for a liability have not been met during employment because the event obligating the company has not yet occurred.

When an accrual is made, the company records an expense and related current liability in the period in which the sick pay benefits are earned by the employees. In measuring the amount of the accrual, the rate of pay the company uses to record the liability is either: (1) the rate for the current period, or (2) the rate for the estimated future time of absence. Since the current period’s rate is more reliable than the future period’s rate, and the difference is unlikely to be material, most companies use the current period’s rate for the accrual. If the amount paid in the future for the compensated absence is larger than the amount of the previous accrual (because of a pay raise or promotion), the company records the difference as an adjustment to the expense recorded in the period of the payment. In other words, the difference is treated as a change in estimate, as we discuss in Chapter 23.

We show the differences in accounting for vacation time and sick pay in the following diagram.
**Example: Compensated Absence**

To show a compensated absence for vacations, assume that the Milton Company has 100 employees who are each paid an average of $200 per day. The company has a policy (which meets the FASB Statement No. 43 conditions) of allowing each employee 12 days of paid vacation per year. The total annual cost of the paid vacations—a form of compensated absence—is $240,000 (100 × 12 × $200). The company records the related current liability on a quarterly basis for interim reporting purposes. Employees are paid monthly; half the employees are in the sales force and the remaining half are in the office staff. Assuming no vacation days were taken in the first quarter of 2008, the company records the expense and accrued liability on March 31, 2008 as follows:

Sales Salaries Expense: Compensated Absences 30,000  
Office Salaries Expense: Compensated Absences 30,000  
Liability for Employees’ Compensation for Future Absences (3/12 × $240,000) 60,000

Some companies prefer to record the debit entry as Vacation Pay Expense. Generally, no payroll taxes are recorded at this time because companies wait until payment of the payroll to do so. Note that as a result of this journal entry the salaries expense is recognized in the period during which the employees work and earn the vacation time and not during the vacation period, thus adhering to the matching principle. The company’s first-quarter interim financial statements include the expense and current liability for compensated absences.

The liability for compensated absences will be satisfied when the employees take their vacations. The company will record the elimination of the current liability, however, when it pays the regular payroll after the employees take their vacations. For example, assume that the $400,000 April 30, 2008 payroll, including paid vacation time taken by the sales and office staff, is as follows:

<table>
<thead>
<tr>
<th></th>
<th>Time Worked</th>
<th>Vacation Taken</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales staff</td>
<td>$194,000</td>
<td>$6,000</td>
</tr>
<tr>
<td>Office staff</td>
<td>193,000</td>
<td>7,000</td>
</tr>
</tbody>
</table>

The company records the payment of this payroll (ignoring payroll taxes) on April 30, 2008 as follows:

Sales Salaries Expense 194,000  
Office Salaries Expense 193,000  
Liability for Employees’ Compensation for Future Absences 13,000  
Cash 400,000

As we discussed earlier, if the $13,000 payroll for vacation time was larger than the respective amount accrued earlier (because of a pay raise or promotion), the company would reduce the liability by the accrued amount, and would add the difference to the two expense accounts. In addition, payroll taxes would normally be recorded at this time. For simplicity however, since we discuss payroll taxes later in the chapter, we do not illustrate them here. If payroll taxes had been recorded, the withheld payroll taxes of the employees would apply to the entire $400,000 as of April 30, 2008 (the date of payment of the salaries and the vacation time) because the taxes are legally assessable. Also, the payroll taxes applicable to the employer would be recorded at this time.

Similar journal entries are made to record the expense for compensated absences and accrue (and eliminate) the liability during the remaining quarters for interim reporting.
purposes. At year-end, the Milton Company reports any remaining balance in the liability account as a current liability on its ending balance sheet.10

Liabilities from Noncancelable Obligations

FASB Statement No. 47 deals with liability issues relating to off-balance-sheet financing. We discussed this topic in Chapter 9 as it relates to inventories; we also discuss it in Chapter 21 as it applies to leasing arrangements. Here we discuss it briefly as it relates to current liabilities. This Statement focuses on accounting for an unconditional purchase obligation. An unconditional purchase obligation is one requiring payment in the future for fixed amounts of goods or services at set prices. If a company has an unconditional (noncancelable) obligation to purchase an asset (e.g., inventory) at a specified price and the market price goes below this price, the company must accrue a loss and record a liability.11 If any part of the future payment falls within a year (or operating cycle, if longer), the company reports this amount as a current liability. This helps users evaluate the company’s liquidity and financial flexibility.

Liabilities from Product Financing Arrangements

FASB Statement No. 49 deals with off-balance-sheet financing transactions in which a company “sells” inventory and agrees to repurchase it (perhaps additionally processed) at a specified price. As we discussed in Chapter 9, the company does not record the transaction as a sale or remove the inventory from its balance sheet. Instead, the company records a liability for the proceeds received. FASB Statement No. 49 also addresses transactions where a company has another entity purchase a product on its behalf. In this case the company records the asset (often an inventory item) and related liability when the product is purchased by the other entity.12 The company reports the amount as a current liability on its balance sheet if it expects to pay it in the next year (or operating cycle, if longer).

Unearned Items

A company’s unearned items (sometimes called deferred revenues) include amounts that it has collected in advance for future sales but has not yet earned and has not recorded as revenues. These unearned items are liabilities because it has not yet provided the product or service.

Examples of unearned items are amounts collected in advance, such as interest, rent, magazine subscriptions, royalties, tickets, tokens, gift certificates, and service contracts. Most of these items are current liabilities. If more than one year (or one operating cycle, if longer) is required in the earning process, then the unearned item is classified as a long-term liability.

The accounting by a company for these unearned items involves the recognition of a liability when it receives the cash. The company makes an adjusting entry at the end of the accounting period to correctly state the amount of revenue earned that it reports on its income statement, and the ending current or long-term liability that it reports on its balance sheet.

10. FASB Statement No. 43 does not specifically address the allocation of the costs of compensated absences to interim periods. If a company did not make quarterly accruals for compensated absences because they were not material, it would need to determine its remaining liability for compensated absences at year-end and make the related accrual journal entry at that time.
SECURE YOUR KNOWLEDGE 13-1

- Liabilities are unavoidable obligations, which may or may not be legally enforceable, that arise from past transactions, and are settled at a future date through the transfer or use of assets.
- Current liabilities provide insights into a company’s liquidity and financial flexibility, and are useful in assessing a company’s future cash flows.
- Most current liabilities are measured, recorded, and reported at their maturity amount.
- Accounts payable, current maturities of long-term debt, dividends payable, advances and refundable deposits, accrued liabilities, and unearned items are examples of liabilities that are contractual in nature.
- A company’s obligation for compensated absences that vest or accumulate and result from employee’s services already rendered must be accrued in the current period, if the payment of the obligation is probable and can be reasonably estimated.

CURRENT LIABILITIES WHOSE AMOUNTS DEPEND ON OPERATIONS

Several kinds of current liabilities relate to operations, and their amounts depend on these operations. Included are liabilities related to sales and use taxes, payrolls, a corporation’s income taxes, and bonus agreements.

Sales and Use Taxes

A sales tax is a tax levied on the transfer of tangible personal property and on certain services. A seller must collect sales tax from the customer and pay the amount—usually on a monthly basis—to the proper governmental authority. A use tax is a tax levied by a state or local governmental unit on goods bought from a nonsales-tax area or sector. It is levied on the buyer of merchandise purchased for the buyer’s own use or consumption. For example, suppose that a company goes out of state to buy trucks because of a better price. When the company registers the trucks in its own state, it has to file a use tax return and pay the tax. A sales tax and a use tax are essentially the same, except for collection and payment. In the following discussion, we only discuss the sales tax in two situations.

Sales Tax Separate from Sales

The first situation is a typical sale when the sales tax is added to the invoice price. For example, assume that Selleroy Company sells merchandise for cash with a retail sales price of $50,000 on which a sales tax of 6% is levied. The company collects $53,000 from its customers and records the collection as follows:

\[
\begin{align*}
\text{Cash} &\quad 53,000 \\
\text{Sales} &\quad 50,000 \\
\text{Sales Taxes Payable} &\quad 3,000
\end{align*}
\]

The Selleroy Company owes the $3,000 sales taxes it collected to the state or local government levying the tax. Therefore, the amount is not part of revenues (sales). Instead the company records it as a current liability, Sales Taxes Payable. Later, when Selleroy files the sales tax return and pays the tax to the governmental agency, it eliminates the current liability.

Sales Tax Included in Sales

The second situation arises when a company includes the amount of the sales taxes directly in the price it charges for merchandise. In this case, at the time of sale it credits the Sales account
for the sum of the sales taxes payable and the sales amount. When a company uses this procedure, since sales taxes generally must be paid monthly, it must make an adjusting entry at the end of each month to reduce the Sales account and to create the current liability, Sales Taxes Payable. For example, suppose that the Smally Company collects sales taxes but records the combined amount of both the sales and the sales taxes in the Sales account. To calculate the sales for the month, the amount in the Sales account must be divided by 1 plus the tax rate. The sales taxes owed are determined by subtracting the calculated sales from the amount in the Sales account. For instance, suppose that at the end of January, the Sales account shows a credit balance of $169,600. Assuming a 6% sales tax on all goods, the company makes an adjusting entry for $9,600 [$169,600 \div (1.06)] at the end of January as follows:

\[
\begin{align*}
\text{Sales} & \quad 9,600 \\
\text{Sales Taxes Payable} & \quad 9,600
\end{align*}
\]

In some cases the sales taxes payable computed by the company may differ slightly from the amount calculated by the governmental authority (e.g., because of the use of graduated sales tax tables). In these cases the company makes an adjustment to Sales Taxes Payable and to Sales. This is a change in accounting estimate.

### Liabilities Related to Payrolls

Companies are required by law to withhold from the pay of each employee a legal amount for the anticipated federal and state (and sometimes local government) taxes payable by employees. They also may voluntarily withhold amounts for union dues, group insurance, retirement savings, and various other amounts payable by the employees to third parties. In addition to these withheld items, federal and state (and sometimes local) laws levy on employers other taxes that are based on the payroll amount. These include social security taxes and unemployment insurance taxes. Since a company must pay these taxes and voluntary withholdings within a few months, it classifies them as current liabilities.

Exhibit 13-2 shows an overview of the withheld groups of items and related voluntary payroll deductions. We discuss each item briefly in the following sections.

#### Payroll Tax Group

The federal income tax law, most state income tax laws, and some local government laws require employers to withhold from the pay of each employee an amount of the anticipated income taxes payable by the employee to the respective governmental units. (Since only a few local governments levy taxes based on the payroll, we ignore these taxes in the following discussion.) The amount withheld depends on the number of exemptions claimed and the amount of income earned by the employee. Employers determine the amount to be withheld from each employee’s pay by using applicable legal rates or by referring to withholding tax tables. The employer must pay withheld amounts to the respective governmental unit at specified times and through specified channels. For example, the withheld federal income taxes must be paid to the Internal Revenue Service either electronically or through local depositories (e.g., banks).

Social security legislation requires that employers withhold Federal Insurance Contribution Act taxes (F.I.C.A.) from the wages of each employee under certain conditions. Also, employers must match the taxes of the employee and pay the sum of both taxes to the Internal Revenue Service along with the income taxes withheld. F.I.C.A. taxes have a dual purpose. The first is to pay federal old-age, survivor, and disability insurance (O.A.S.D.I.) benefits. The second is to pay federal hospital insurance (Medicare) benefits. Together, these taxes are referred to as social security taxes. As shown in Exhibit 13-2, the 2005 F.I.C.A. taxes are 15.30% (6.20% + 1.45% + 6.20% + 1.45%) on the first $90,000 earned by each employee. One half of this amount—7.65% (6.20% + 1.45%)—is paid by the employee; the other half is paid by the employer. On income between $90,000 and the total income earned by the employee, additional F.I.C.A. taxes of 1.45% are paid by both the employee and employer.
The actual tax rates and wage base for future years will be determined by Congress. Because Congress changes (generally increases) these items frequently, for simplicity in the following examples and homework, we will use an assumed rate of 16%—8% on the employee and 8% on the employer—and a taxable wage base of $90,000 on both F.I.C.A. taxes.

The fifth and sixth taxes shown in Exhibit 13-2 are unemployment insurance taxes, another type of social security tax. These taxes are used by governmental units to make payments for a limited time to individuals who become unemployed. The Federal Unemployment Tax Act (F.U.T.A.) requires a tax with a maximum rate of 6.2% to be levied wholly on employers of one or more persons, but the rate applies to only the first $7,000 paid to each employee. The law provides, however, that 5.4% of the 6.2% is payable to the state, assuming that the state levies an approved unemployment insurance tax. Thus, in these cases, the net effective federal unemployment tax rate is 0.8%. Most state laws allow for a reduction of the 5.4% tax through merit-rating plans for those employers who maintain steady employment, because that reduces the amount paid from the fund.

**Voluntary Payroll Deduction Group**

Through a contractual arrangement between individual employees and their employer, many kinds of payroll deductions can be authorized. Typical examples of these voluntary contractual deductions are for payment of group hospital insurance, accident insurance, life insurance, union dues, government bonds, and tax-sheltered retirement savings. These payroll deductions are made for the convenience of the employees of a company.

**Accounting for Payroll Taxes and Deductions**

To show the accounting for payroll taxes and voluntary payroll deductions, assume that the Wager Corporation summarizes the following weekly payroll from its payroll records during early February 2008:

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales staff</td>
<td>$20,000</td>
<td>$1,600</td>
<td>$1,460</td>
<td>$600</td>
<td>$200</td>
<td>$16,140</td>
</tr>
<tr>
<td>Office staff</td>
<td>8,000</td>
<td>640</td>
<td>520</td>
<td>400</td>
<td>160</td>
<td>6,280</td>
</tr>
<tr>
<td></td>
<td><strong>$28,000</strong></td>
<td><strong>$2,240</strong></td>
<td><strong>$1,980</strong></td>
<td><strong>$1,000</strong></td>
<td><strong>$360</strong></td>
<td><strong>$22,420</strong></td>
</tr>
</tbody>
</table>

*Assumed 8% rate.
Further assume that the effective federal and state unemployment tax rates are 0.8% and 5.4%, respectively, and that all wages are subject to all payroll taxes. The company makes the following two journal entries to record the payment of the payroll and the payroll taxes imposed on the employer:

1. To record salaries and employee withholding items:

   Sales Salaries Expense 20,000
   Office Salaries Expense 8,000
   F.I.C.A. Taxes Payable 2,240
   Employee Federal Income Taxes Withholding Payable 1,980
   Employee State Income Taxes Withholding Payable 1,000
   Employee Union Dues Withholding Payable 360
   Cash 22,420

2. To record employer payroll taxes:

   Payroll Taxes Expense 3,976
   F.I.C.A. Taxes Payable (8% × $28,000) 2,240
   Federal Unemployment Taxes Payable (0.8% × $28,000) 224
   State Unemployment Taxes Payable (5.4% × $28,000) 1,512

The company reports the various “payable” accounts as current liabilities. Instead of recording Payroll Taxes Expense in the second entry, the company may increase the respective Salaries Expense accounts for the appropriate amounts that are the additional cost of employing the sales and office staff. Regardless of approach, when Wager Corporation pays the payroll deductions, it eliminates the related current liability accounts.

**Income Taxes Payable**

The income of corporations is subject to a federal income tax separate from that of individuals. In addition, corporations may be subject to state and foreign income taxes. The federal corporate income tax imposes a rate schedule for 2006 that is a four-step progressive structure, which ranges from a low of 15% on taxable income of less than $50,000 to 35% on taxable income over $10,000,000. Because Congress may change the income tax rates and because actual income tax computations are complex, for simplicity we generally assume an effective income tax rate (e.g., 30%) in our discussions and homework.

A corporation must file its Form 1120, Corporate Income Tax Return, two and one half months after the end of the taxable fiscal year. Most corporations must pay estimated taxes throughout the fiscal year. The Internal Revenue Service provides guidelines for the calculation of both estimated and actual income taxes. Since these guidelines are subject to change, we do not discuss them in this book.

When a corporation accrues its estimated income taxes for either interim or end-of-period financial statement purposes, it records a debit to Income Tax Expense and a credit to a current liability, Income Taxes Payable. Later, when the corporation pays its actual income taxes, it records a debit to Income Taxes Payable (to eliminate the current liability) and a credit to Cash. If the estimated amount differs from the actual amount, the corporation makes an adjustment to the Income Tax Expense account. This is a change in accounting estimate.

**Bonus Obligations**

As incentives to certain employees—particularly officers and managers—to increase company earnings, many companies establish an earnings-based bonus agreement. The
bonus is usually payable shortly after the end of the year. The bonus, which is additional salary, is an operating expense of the company. The company records the bonus as an expense and as a current liability when it has been earned by the employees. Also, the company deducts the bonus payments when computing its taxable income. Legal documents for bonus agreements may be written in several different ways. Two typical plans provide for the calculation of the bonus as follows:13

1. The bonus is based on the corporation’s income after deducting income taxes, but before deducting the bonus.
2. The bonus is based on the corporation’s net income after deducting both the bonus and the income taxes.

In either of these two approaches, the corporation cannot determine its income tax until it calculates the bonus. Thus, the computation requires solving two simple simultaneous equations. Example 13-1 shows the computation of the bonus and income tax for each of these approaches.

The Bonex Corporation records the bonus and income taxes in Part 2 of Example 13-1 as follows:

1. To record the bonus:

<table>
<thead>
<tr>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salaries Expense (Officer’s Bonus)</td>
</tr>
<tr>
<td>Officer’s Bonus Payable</td>
</tr>
</tbody>
</table>

---

13. Two other approaches are: (1) the bonus could be based on the corporation’s income before income taxes and before the bonus, or (2) the bonus could be based on the corporation’s income before income taxes and after the bonus is deducted. The computations involved in these two approaches are similar to (but simpler than) the methods we discuss and we do not present them here.
2. To record the income tax expense:

\[
\begin{align*}
\text{Income Tax Expense} & \quad \overline{72,897} \\
\text{Income Taxes Payable} & \quad \overline{72,897}
\end{align*}
\]

The Bonex Corporation reports both the Officer’s Bonus Payable and Income Taxes Payable as current liabilities on its balance sheet. Note that bonuses \textit{may} have an undesirable
effect on management’s decisions regarding accounting principles. That is, management might choose an accounting principle, method, or procedure only because it increases the company’s income, thereby increasing management’s bonuses. This action is consistent with “agency theory” that we discussed in Chapter 1.

**Current Liabilities Requiring Amounts to be Estimated**

A number of liabilities have amounts that a company must estimate as of the balance sheet date. We discuss the obligations that typically are current liabilities in this section. These include property taxes, warranties, and premium obligations. These items are specific types of “contingent liabilities.” We discuss contingencies in the following section.

**Property Taxes**

Property taxes are assessed by municipal, county, and some state governments on the value of certain property as of a given date. They become a lien against the property at a date specified by law. Legally, a liability arises on this lien date. The lien date may precede the billing date by several months. For example, in Columbia, Missouri, the property tax is assessed on the value of the property as of January 1 of each year. The date that the tax becomes a lien against the property is July 1. The fiscal year of the city is July 1 to June 30. Property tax statements are mailed to property owners during November. Thus if a company records its property taxes before it receives the tax statement, it must estimate the amount. Also, the accounting year of the company may be different from the fiscal year of the municipality. In this case, the issue arises as to when the company should record the property tax liability and in which accounting period the property taxes should be expensed.

A company should accrue property taxes in equal monthly amounts during the fiscal periods of the taxing authority for which the taxes are levied. The accounting records then will show, at any closing date, the appropriate current liability or prepaid asset. This method is preferred because the company recognizes the property tax expense in the same period it receives services from the governmental unit(s).

It is not difficult to estimate the amount of property taxes applicable to the fiscal year of the taxing authority. By law, the tax rate generally cannot vary too much from past rates. Also, the value of the property being taxed is generally determined by the municipality with a notification to the owner. Thus, the company can determine the total valuation subject to the tax. The company calculates the estimated property tax by applying the estimated rate to the assessed valuation amount. If a variation between the actual property taxes and the estimated property taxes occurs, the company accounts for it as a change in accounting estimate.

**Example: Recording Property Taxes**

Assume that the Ezzell Company’s fiscal year-end is December 31. The fiscal year-end for the town and county in which the Ezzell Company is located is June 30 of the next year. The tax becomes a lien against the property on July 1 of each year. The estimated property taxes for the period July 1, 2007 to June 30, 2008 are $7,200. The tax bill is mailed in October with a requirement that the tax be paid before December 31, 2007. The tax bill for the Ezzell Company reported an actual tax of $7,290, and the company pays this amount on October 31, 2007. The company records monthly property tax adjustments for interim statements required by its management.

---

Assuming that the Ezzell Company did not recognize any property tax liability at the lien date and it records the property tax on a monthly accrual basis, it records the following series of journal entries:

**Three Monthly Entries: July 31–September 30, 2007**

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property Tax Expense ($7,200 / 12)</td>
<td>600</td>
<td></td>
</tr>
<tr>
<td>Property Taxes Payable</td>
<td></td>
<td>600</td>
</tr>
</tbody>
</table>

**October 31, 2007: Payment of Property Taxes**

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property Taxes Payable</td>
<td>1,800</td>
<td></td>
</tr>
<tr>
<td>Prepaid Property Taxes</td>
<td>5,490</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td></td>
<td>7,290</td>
</tr>
</tbody>
</table>

**Three Monthly Entries: October 31–December 31, 2007**

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property Tax Expense</td>
<td></td>
<td>610</td>
</tr>
<tr>
<td>Prepaid Property Taxes</td>
<td></td>
<td>610</td>
</tr>
</tbody>
</table>

The company reports an $1,800 ($600 × 3) current liability for property taxes on its September 30, 2007 interim balance sheet. Note that the $610 amount in the last journal entry is the result of allocating the $90 difference ($7,290 – $7,200) between the actual and estimated property taxes to the remaining 9-month period ending June 30, 2008. That is, the $610 is computed by subtracting the previously estimated property tax expense to date ($600 × 3) from the total actual property tax ($7,290) and dividing the difference ($5,490) by the remaining months (9) in the year.

Assuming that Ezzell had recorded $598 each month from January 31 to June 30, 2007 (the portion of the tax authority’s *previous* fiscal year occurring during the company’s *current* accounting year), its property tax expense for 2007 is $7,218 [(($598 × 6) + ($600 × 3) + ($610 × 3)]

---

**Warranty Obligations**

Product warranty agreements require the seller, over a specified time after the sale, to correct any defect in the quality of the merchandise sold, to replace the item, or to refund the selling price. These promises are made by manufacturers and retailers to promote sales.

The period of the warranty may span two or more accounting periods. The matching principle requires that a company recognize the warranty expense in the period during which it makes the sale, because the flaws in the merchandise are assumed to be present at the time of the sale. The actual use of resources to correct the defects in the merchandise, however, may occur partly in the period of sale and partly in a later period. Consequently, recognition of the warranty expense in the period of sale and the resulting current liability requires a company to estimate the costs it will incur after the sale to correct any defects. There are three methods of accounting for warranty costs:

- expense warranty accrual method,
- sales warranty accrual method, and
- modified cash basis method.

We discuss each method in the following sections.

**Expense Warranty Accrual Method**

Under the expense warranty accrual method, a company recognizes the estimated warranty expense and a liability for future performance in the period of sale. This method assumes that the company makes the warranty offer to increase sales; hence, the estimated warranty expense is matched against these sales. The company classifies the estimated portion of the warranty liability for the next accounting period (or operating
cycle, if longer) as a current liability; it classifies the remainder as a long-term liability. During the period when it uses resources to fulfill the warranty agreement, it debits the liability and credits the respective assets.

**Example: Expense Warranty Accrual Method** Assume that Anglee Machinery Corporation begins production on a new machine in April 2007 and sells 200 of these machines at $6,000 each by December 31, 2007. Each machine carries a warranty for one year. Experience from the sale of similar machinery in the past has shown that the warranty costs will average $150 per unit, or a total of $30,000 (200 × $150). The corporation spent $5,000 in 2007 and $25,150 in 2008 to fulfill the warranty agreements for the 200 machines sold in 2007. The company records this information under the expense warranty accrual method for the year 2007 in a series of journal entries as follows:

**Sale of 200 Machines during April–December, 2007**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash or Accounts Receivable ($6,000 × 200)</td>
<td>1,200,000</td>
</tr>
<tr>
<td>Sales</td>
<td>1,200,000</td>
</tr>
</tbody>
</table>

**Recognition of Warranty Expense for Period, April–December, 2007**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Warranty Expense ($150 × 200)</td>
<td>30,000</td>
</tr>
<tr>
<td>Estimated Liability under Warranties</td>
<td>30,000</td>
</tr>
</tbody>
</table>

**Payment or Incurrence of Warranty Costs for Period, April–December, 2007**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estimated Liability under Warranties</td>
<td>5,000</td>
</tr>
<tr>
<td>Cash (or other assets)</td>
<td>5,000</td>
</tr>
</tbody>
</table>

The company reports the Warranty Expense as an operating expense on its 2007 income statement. It reports the remaining $25,000 ($30,000 accrued − $5,000 paid) unpaid Estimated Liability under Warranties as a current liability on its December 31, 2007 balance sheet since the warranty period is a year in length.

The company records the transactions in 2008 relating to the 200 machines sold in 2007 as follows:

**Payment or Incurrence of Warranty Costs during 2008**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estimated Liability under Warranties</td>
<td>25,000</td>
</tr>
<tr>
<td>Warranty Expense</td>
<td>150</td>
</tr>
<tr>
<td>Cash (or other assets)</td>
<td>25,150</td>
</tr>
</tbody>
</table>

In the preceding journal entry, the actual warranty costs are $150 more than were estimated. The company debited this amount to Warranty Expense for 2008 because it resulted from a change in accounting estimate.

**Sales Warranty Accrual Method**

Many companies encourage customers to buy a “service contract” when they buy merchandise. Service contracts require customers to make fixed payments for future services. In other cases, there is no explicit separate service contract but the sales price of each product includes the sale of two items: the product and an implied warranty contract. Use of the sales warranty accrual method separates the accounting for these two items *even when no separate service contract is involved*. Under this method, a company assumes that its revenue from the implied warranty contract is equal to the estimated warranty costs, and it defers and recognizes revenue in an amount equal to the warranty costs it incurred. This is a *cost recovery approach to warranty revenue recognition*. (We discuss the cost recovery method of revenue recognition in Chapter 18.)

**Example: Sales Warranty Accrual Method** In the case of the Anglee Machinery Corporation, assume that the $6,000 selling price of each machine includes both an
implied service contract (sale of the warranty) of $150 and a sale of a machine with a selling price of $5,850 ($6,000 – $150). Under the sales warranty accrual method, the company records the transactions for 2007 as follows:

**Sale of 200 Machines during April–December, 2007**

- **Cash or Accounts Receivable** ($6,000 × 200) 1,200,000
- **Sales** ($5,850 × 200) 1,170,000
- **Unearned Warranty Revenue** ($150 × 200) 30,000

**Recognition of Warranty Expense for Period, April–December, 2007**

- **Warranty Expense** 5,000
- **Cash (or other assets)** 5,000

**Recognition of Warranty Revenue for Period, April–December, 2007**

- **Unearned Warranty Revenue** 5,000
- **Warranty Revenue** 5,000

The company reports the $25,000 balance ($30,000 – $5,000) in Unearned Warranty Revenue as a current liability on its December 31, 2007 balance sheet. Note that on the company’s 2007 income statement the Sales amount is $30,000 smaller than under the expense warranty accrual method. The 2007 income statement lists Warranty Revenue of $5,000 and also Warranty Expense of $5,000 (as compared to $30,000 under the expense warranty accrual approach). Thus, while the company’s net income for 2007 is the same under each method, the amounts of revenue and expense and the classifications of revenues are different, reflecting the different nature of revenue earned.

The company records the transactions for 2008 related to the 200 machines sold in 2007 as follows:

**Recognition of Warranty Expense during 2008**

- **Warranty Expense** 25,150
- **Cash (or other assets)** 25,150

**Recognition of Warranty Revenue during 2008**

- **Unearned Warranty Revenue** 25,000
- **Warranty Revenue** 25,000

Generally, it is assumed that a company realizes no profit from the sale of an implied warranty contract. As a matter of fact, in the Anglee Machinery Corporation example, there is a loss of $150. This loss results from the actual warranty costs exceeding the estimated costs by that amount. Thus, this method assumed the most conservative possible recognition of that part of the revenue related to the warranty.

**Modified Cash Basis Method**

Under the modified cash basis, a company records the warranty costs as an expense during the period in which it makes the repairs to merchandise under warranty. Thus, it recognizes the expense in the period of the repair, and this period may be later than the period of the sale. The modified cash basis is the only method accepted for federal income tax purposes. For this reason companies often use it for financial reporting if the results are not materially different than those from either of the two previous methods. Since the company does not estimate and recognize the warranty costs during the period of sale, it does not record a liability for these future warranty costs. The company records a current liability only if it incurs an obligation for the repair that it does not pay at the time of the repair. This method is not appropriate for financial reporting because it violates the matching principle. In general, since the company expects to use resources in the future, a liability does in fact exist from the date of
sale to the end of the warranty period. Therefore, the modified cash basis is conceptually unsound. It is justified for accounting under two conditions: (1) from a cost/benefit standpoint, when the warranty period is relatively short, (2) when it is not possible for the company to make a reliable estimate of the warranty obligation amount at the time of sale, or (3) when its results are not materially different from the expense warranty accrual method or the sales warranty accrual method.

**Premium and Coupon Obligations**

Many companies offer premiums such as toys, dishes, CDs, and small appliances in exchange for labels, coupons, box tops, and wrappers from their products. Other companies offer coupons printed in newspapers and magazines that can be used to reduce the purchase price of their products. Still others offer a cash rebate when customers return a cash register receipt for the purchase of their products. Many of these offers expire after a specified time, but some do not have an expiration date. All of these offers are intended to increase a company’s sales. Accordingly, a company matches the related costs as expenses against revenues in the period of sale. Also, at the end of the accounting period, the company reports any outstanding offers that it expects to be redeemed or claimed within the next year (or operating cycle, if longer) as a current liability.

**Example: Premium Obligation** Assume that on October 1, 2007, the American Spaghetti Corporation began offering to customers a CD in return for 30 spaghetti can labels. This offer expires on April 1, 2008. The cost of each premium CD is $2. Based on past experience, the company estimates that only 60% of the labels will be redeemed. During 2007, the company purchased 6,000 CDs. In 2007, it sold 300,000 cans of spaghetti at $1.80 per can. From these sales 105,000 labels were returned for redemption in 2007. The company records the following series of journal entries in 2007 to match expenses against revenues and to record its current liabilities:

**Purchase of 6,000 CDs**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory of Premium CDs</td>
<td>12,000</td>
</tr>
<tr>
<td>Cash (or Accounts Payable)</td>
<td></td>
</tr>
</tbody>
</table>

**Sale of 300,000 Cans of Spaghetti**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash (or Accounts Receivable)</td>
<td>540,000</td>
</tr>
<tr>
<td>Sales</td>
<td>540,000</td>
</tr>
</tbody>
</table>

**Redemption of 105,000 Labels**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Premium Expense $[(105,000 ÷ 30) \times $2]$</td>
<td>7,000</td>
</tr>
<tr>
<td>Inventory of Premium CDs</td>
<td>7,000</td>
</tr>
</tbody>
</table>

**End-of-Year Recording of Estimated Liability for Outstanding Premium Offers**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Premium Expense Estimated Premium Claims Outstanding</td>
<td>5,000</td>
</tr>
</tbody>
</table>

The company computes the year-end adjustment to premium expense as follows:

- Total spaghetti cans (with labels) sold in 2007: 300,000
- Total labels estimated for redemption (60% \times 300,000): 180,000
- Deduct labels redeemed during 2007 (105,000): 105,000
- Estimated number of labels for future redemption: 75,000
- Premium expense for estimated future redemptions $[(75,000 ÷ 30) \times $2] $5,000
The company reports the Premium Expense as a selling expense on its 2007 income statement. The company reports the Inventory of Premium CDs as a current asset and the Estimated Premium Claims Outstanding as a current liability on its December 31, 2007 balance sheet since the offer expires in less than a year.

The future redemptions of these labels in 2008 will require a debit to the Estimated Premium Claims Outstanding liability account and a credit to Inventory of Premium CDs. If customers redeem fewer labels than the company estimated, it disposes of the remaining CDs. It debits Premium Expense and credits Inventory of Premium CDs for the remaining cost because it resulted from a change in accounting estimate.

Some companies prefer to record an estimate of the premium expense and current liability at the time of sale and reduce the liability each time a premium is claimed. Others prefer to record an estimate of the entire current liability at the end of the accounting period, but reduce the liability as premiums are claimed during the period. In either case, the effects on the financial statements are the same as those we showed.

Advertising Costs

Companies are required to expense their advertising costs as incurred or at the first time the advertising takes place because it is difficult to measure the future economic benefits. This advertising can be very expensive. For instance, a 30-second advertisement during the 2005 Super Bowl cost $2.4 million dollars. A company running such an ad would expense the cost of preparing it as well as the $2.4 million fee at the time the ad was first run (i.e., at the time of the Super Bowl).

In the case of “direct-response” advertising, however, the AICPA issued a Statement of Position that requires companies to record certain costs initially as assets. Direct-response advertising is advertising that is expected to result in a customer’s decision to buy the company’s product based on a specific response to the advertising. The specific response must be documented through, for instance, a coded coupon turned in by the...
customer or a coded order form included with an advertisement. In this case, the company capitalizes specific costs if it has evidence (e.g., historical patterns) that they will result in future revenues in excess of future costs. If this evidence is not available, the company expends the direct advertising costs as incurred. In a “cease-and-desist order,” several years ago America Online (AOL) was required to pay a $3.5 million fine because it violated GAAP with regard to its direct advertising costs. AOL had been recording as assets the costs of sending its disks to potential customers. The SEC found that the Internet marketplace was too unstable for AOL to have evidence that its future revenues from these potential customers would exceed the amount of its capitalized costs.

The costs of direct-response advertising that a company capitalizes include (1) incremental direct costs incurred in transactions with independent third parties (e.g., costs of artwork, magazine space, mailing), and (2) payroll costs for activities (e.g., idea development, writing advertising copy) of employees directly related to the advertising. As we discussed in the previous section, also included as assets are premiums, contest prizes, gifts, and similar promotions directly related to the direct-response advertising activities. Costs for administration and occupancy (e.g., depreciation) are not included as assets. The costs of direct-response advertising that are reported as assets are amortized as advertising expense over the period during which the future benefits are expected to be received (e.g., up to the date a coupon expires).15 A company generally reports any unpaid direct advertising costs as current liabilities because they will be paid in the near future.

**Secure Your Knowledge 13-2**

- Sales and use taxes, payroll and payroll taxes, corporate income taxes, and bonus agreements are examples of current liabilities whose amounts depend on operations.
- In addition to the amounts withheld from employees’ pay, a company also has a current liability for payroll taxes (e.g., social security, Medicare) until these amounts are sent to the appropriate governmental agencies.
- Property taxes are usually estimated and accrued in equal monthly amounts during the fiscal year of the taxing authority.
- When a warranty offer is made to stimulate sales, warranty obligations are estimated and recognized in the period of the sale even though the actual use of resources to satisfy the warranty agreement may not occur until a future period.
- If the warranty is considered a separate element from the sale itself (e.g., an implied service contract), revenue equal to the warranty costs must be deferred (creating a current liability) until service is actually performed or the warranty period expires.
- The accounting for obligations relating to premiums and coupons is similar to that of warranties—any obligation is estimated and recorded in the period of the sale.

**Contingencies**

External users are interested in information that helps them assess the amounts, timing, and uncertainty of the net cash inflows of a company. They need accounting information that has predictive value to help them forecast the future outcome of past or present events. The financial information that a company reports in its financial statements is based primarily on transactions that have affected it. However, there may be some information available at

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year-end about the company that is not yet recorded in its accounting system but may be useful in predicting what might happen to the company. These items commonly are referred to as “contingencies.”

Specifically, FASB Statement No. 5 defines a **contingency** for a company as:

> an existing condition, situation, or set of circumstances involving uncertainty as to a possible gain (a “gain contingency”) or loss (a “loss contingency”) that will be resolved when a future event occurs or fails to occur.\(^{16}\)

We discuss gain contingencies later in this section. Examples of loss contingencies are product warranties and premium offers that we discussed in earlier sections. We will discuss other loss contingencies later.

When a loss contingency exists for a company, the likelihood that the future event will confirm the loss can vary over a wide range. FASB Statement No. 5 uses the terms **probable**, **reasonably possible**, and **remote** to identify three areas within this range. These terms are defined as follows:

1. **Probable.** The future event is *likely* to occur.
2. **Reasonably possible.** The chance of the future event occurring is *more* than remote but *less* than likely.
3. **Remote.** The chance of the future event occurring is *slight*.\(^{17}\)

A company’s **accounting for a loss contingency** depends on the likelihood that the future event will occur. Two separate methods of accounting are defined by FASB Statement No. 5.

1. **Recognition in Financial Statements.** A company accrues an estimated loss from a loss contingency and reports a loss (or expense) and a liability (or as a reduction in an asset) in its financial statements if *both* of the following conditions are met:
   a. The company has information prior to issuing its financial statements that indicates it is **probable** that a liability has been incurred (or an asset impaired) at the date of the financial statements.
   b. The company can **reasonably estimate** the amount of the loss. In certain situations a company’s reasonable estimate of the loss may be a range of amounts. When some amount within the range is a better estimate than any other amount in the range, the better estimate is **accrued**. When no amount within the range is a better estimate, the **minimum amount in the range** is **accrued** because it is not likely that the loss will be less than this minimum.\(^{18}\)

2. **Disclosure in Notes to Financial Statements.** If either of the preceding conditions are not met but there is at least a reasonable possibility that a loss may have been incurred, then the company discloses the loss contingency in the notes to its financial statements. (Some remote loss contingencies are also disclosed in the notes, as we discuss later.)

To summarize, a company recognizes a loss contingency in its financial statements if the future event is **probable** and if its amount can be **reasonably estimated**. If a liability is recorded in this process, it is *not* necessary to know the payee or the date that it is to be paid. A company discloses a loss contingency in the notes to its financial statements if one of

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\(^{16}\) “Accounting for Contingencies,” FASB Statement of Financial Accounting Standards No. 5 (Stamford, Conn.: FASB, 1975), par. 1. (Emphasis added.)

\(^{17}\) *Ibid.*, par. 3. (Emphasis added.)

\(^{18}\) “Reasonable Estimation of the Amount of a Loss,” FASB Interpretation No. 14 (Stamford, Conn.: FASB, 1976), par. 3.
these criteria is not met and if there is a reasonable possibility that the company may have incurred a loss.

The following diagram is helpful in determining how to report a loss contingency.

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**Accrual of Loss Contingencies**

Companies usually accrue certain loss contingencies because they are probable and can be reasonably estimated. They include the noncollectibility of receivables (bad debts), sales returns and allowances (which we discussed in Chapter 7), and the obligations related to property taxes, product warranties, and premium offers that we discussed earlier in this chapter. Several other loss contingencies may be accrued provided they meet the two stated conditions. These include the threat of expropriation of assets, pending litigation, actual claims and assessments, guarantees of indebtedness of others, and agreements to repurchase receivables (or the related property) that were sold. On the other hand, at least three contingencies are usually not accrued. These include the uninsured risk of damage to company property by fire, explosion, or other hazards, general or unspecified business risks, and risk of loss from catastrophes assumed by property and casualty insurance companies. For this latter group of items, a company’s mere exposure to risk does not mean that an asset is impaired or that a liability has been incurred.
When a company recognizes a loss contingency, it records a debit to an expense (or loss) account and a credit to a liability account, asset account, or contra-asset account. For example, assume Roberts Company estimates that its bad debt expense is $12,000 for 2007. The company records this loss contingency at the end of the year as follows:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bad Debt Expense</td>
<td>12,000</td>
</tr>
<tr>
<td>Allowance for Doubtful Accounts</td>
<td>12,000</td>
</tr>
</tbody>
</table>

**Lawsuits**

Accounting for lawsuits is a very difficult issue. A defendant company must analyze these lawsuits as loss contingencies. The company should consider the opinion of its legal counsel, the nature of the litigation, its previous experience in similar cases, and management reaction to the lawsuit. If the cause of the litigation has occurred before the date of its financial statements, if the loss of the lawsuit is probable, and if the loss amount can be reasonably estimated, the company must accrue the loss and related liability. Management may decide only to disclose the pending lawsuit in the notes to the financial statements because the loss is not probable or because it is not possible to reasonably estimate the loss. However, this decision may be influenced by management’s desire to maintain higher reported earnings and to minimize the amount of reported liabilities.

In regard to potential unfiled lawsuits and other possible assessments and unasserted claims, a company must determine the likelihood that the suit may be filed or the claim or assessment asserted, and the probability of an unfavorable outcome. For example, if Patterson Corporation is being investigated for a possible patent infringement suit, it must determine the probability that the suit will be filed and that the suit will be lost. If these future events are probable, if the loss is reasonably estimable, and if the cause for action has occurred before the date of the issuance of the financial statements, it must accrue the loss and related liability.

In practice, companies usually do not accrue the costs of actual or pending litigation. In the case where a company is being sued for a specific situation by a single complainant, it is unlikely that the company will have sufficient evidence to conclude that the likelihood of loss is probable. Or in a situation where there is a lack of precedence relating to the particular circumstances of a lawsuit, even if a company admits guilt it is unlikely to conclude that it can reasonably estimate the amount of the loss. However, a company may be sued by many complainants over the same, or similar, issue (a “class action” suit) in which case the thresholds of probable and reasonably estimable may be reached. In this situation, the company typically will accrue the costs of the litigation. For instance, Union Carbide Corporation (a wholly owned subsidiary of Dow Chemical Company) has accrued losses of $1.6 billion in regard to its potential liability for a class action lawsuit involving its manufacture of asbestos.

**Disclosure of Loss Contingencies in the Notes to the Financial Statements**

If a company does not accrue a loss for a loss contingency, it must disclose the contingency when there is at least a reasonable possibility that it has incurred a loss. Recall that a loss contingency is reasonably possible when the chance of the future event occurring is more than remote but less than likely. Most of the examples of loss contingencies listed earlier could fall into this category, particularly the threat of expropriation of assets, pending or threatened litigation, and actual or possible claims and assessments. For this type of loss contingency, a company makes this disclosure in the notes to its financial statements. The disclosure must indicate the nature of the contingency and give an estimate of the possible loss or range of loss or state that such an estimate cannot be made.

Certain loss contingencies, where the possibility of loss is only remote, are also disclosed in the notes to a company’s financial statements. Examples of these loss contingencies include direct and indirect guarantees of indebtedness of others, obligations of commercial banks under “standby letters of credit,” and guarantees to repurchase receivables that have been sold or otherwise assigned. An indirect guarantee involves an agreement requiring
one company to transfer funds to another entity if specified events occur whereby (1) the funds are legally available to creditors of the other entity, and (2) those creditors may enforce that entity's claims against the company under the agreement. A common characteristic of these remote contingencies is a guarantee, normally with a right to proceed against an outside party in the event that the guarantor has to satisfy the guarantee. The disclosure of this group of guarantees must include the nature and amount of the guarantee and, if estimable, the value of any recovery that could be expected to result. This latter requirement would result from the guarantor's right to proceed against an outside party.

**Disclosure of Gain Contingencies in the Notes to the Financial Statements**

If a company has a gain contingency, there is a potential increase in its assets or a potential decrease in its liabilities. Adhering to the convention of conservatism and to the revenue recognition criteria, *FASB Statement No. 5* requires that these gains usually are not accrued, but are disclosed in the notes to the company's financial statements. It states:

(a) Contingencies that might result in gains usually are not reflected in [a company's] accounts since to do so might be to recognize revenue prior to its realization.

(b) Adequate disclosure shall be made of contingencies that might result in gains, but care shall be exercised to avoid misleading implications as to the likelihood of realization.

Therefore, gain contingencies are generally recognized when realized. An example of a gain contingency is where a company is suing another company for patent infringement, and the probability of winning the suit is excellent. A second example is a probable expropriation of a company's property by a government where probable reimbursement will exceed the book value of the property expected to be taken over by the government.

**Executory Contracts**

An *executory contract* is a contract in which two parties agree to a future exchange of resources or services, but neither party has performed any of its responsibilities. Examples of executory contracts include an unused line of credit, a purchase commitment, an agreement to pay future compensation, and a contract for having a factory built. For instance, Mariah Carey and Universal agreed to a $20 million contract for future albums. Since in an executory contract (sometimes called an *unexecuted* contract) no exchange of resources or services has occurred, no liability (or asset reduction) or contingent liability exists. However, when an executory contract has a likely material impact on the future cash flows of a company, the company discloses this information in the notes to its financial statements to enhance the predictive value of the information.

**Illustrations of Contingency Disclosures**

Real Report 13-1 illustrates the loss contingency disclosures in the notes to the 2004 financial statements of several companies. These disclosures involve the potential violation of environmental regulations by Baker Hughes, a value-added tax dispute of Englehard, and financial guarantees of customers' lines of credit by Whirlpool.

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20. *FASB Statement No. 5*, op. cit., par. 10 and 12.
21. Ibid., par. 17.
Real Report 13-1  Disclosure of Contingencies

BAKER HUGHES INCORPORATED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (in part):
NOTE 16. Commitments and Contingencies (in part)

[The Company has] been identified as a potentially responsible party (“PRP”) in remedial activities related to various Superfund sites. We participate in the process set out in the Joint Participation and Defense Agreement to negotiate with government agencies, identify other PRPs, determine each PRP’s allocation and estimate remediation costs. We have accrued what we believe to be our pro-rata share of the total estimated cost of remediation and associated management of these Superfund sites. This share is based upon the ratio that the estimated volume of waste we contributed to the site bears to the total estimated volume of waste disposed at the site. Applicable United States federal law imposes joint and several liability on each PRP for the cleanup of these sites leaving us with the uncertainty that we may be responsible for the remediation cost attributable to other PRPs who are unable to pay their share. No accrual has been made under the joint and several liability concept for those Superfund sites where our participation is minor since we believe that the probability that we will have to pay material costs above our volumetric share is remote. We believe there are other PRPs who have greater involvement on a volumetric calculation basis, who have substantial assets and who may be reasonably expected to pay their share of the cost of remediation. For those Superfund sites where we are a major PRP, remediation costs are estimated to include recalcitrant parties. In some cases we have insurance coverage or contractual indemnities from third parties to cover the ultimate liability.

Our total accrual for environmental remediation is $13.6 million and $15.6 million, which includes accruals of $3.6 million and $4.3 million for the various Superfund sites, at December 31, 2004 and 2003, respectively. The determination of the required accruals is subject to uncertainty, including the evolving nature of environmental regulations and the difficulty in estimating the extent and type of remediation activity that will be utilized. We believe that the likelihood of material losses in excess of the recorded accruals is remote.

ENGELHARD CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (in part):
NOTE 22. Litigation and Contingencies (in part)

The Company is involved in a value-added tax dispute in Peru. Management believes the Company was targeted by corrupt officials within a former Peruvian government... In late October 2000, a criminal proceeding alleging tax fraud and forgery related to this value-added tax dispute was initiated against two Lima-based officials of Engelhard Peru, S.A. Although Engelhard Peru, S.A. is not a defendant, it may be civilly liable in Peru if its representatives are found responsible for criminal conduct. In its own investigation, and in detailed review of the materials presented in Peru, management has not seen any tax fraud by these officials. Accordingly, Engelhard Peru, S.A. is assisting in the vigorous defense of this proceeding. Management believes the maximum economic exposure is limited to the aggregate value of all assets of Engelhard Peru, S.A. That amount, which is approximately $30 million, including unpaid refunds, has been fully provided for in the accounts of the Company.

WHIRLPOOL CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (in part):
NOTE (9) Guarantees, Commitments and Contingencies (in part)

The Company has guarantee arrangements in place in a Brazilian subsidiary. As a standard business practice in Brazil, the subsidiary guarantees customer lines of credit at commercial banks, supporting purchases from the Company, following its normal credit policies. In the event that a customer were to default on its line of credit with the bank, the subsidiary would be required to satisfy the obligation with the bank, and the receivable would revert back to the subsidiary. As of December 31, 2004 and December 31, 2003, these amounts totaled $184 million and $109 million, respectively. The only
We discuss two additional liability classification issues in this section: (1) short-term debt expected to be refinanced, and (2) classification of obligations that are callable by the creditor.

**Short-Term Debt Expected to Be Refinanced**

Generally, a company classifies debt that is maturing within one year (or the operating cycle, if longer) as a current liability. This classification affects the company’s liquidity ratios such as its current ratio and acid-test ratio. In some situations, short-term debt that is expected to be refinanced on a long-term basis is not classified as a current liability. A company may refinance its short-term debt on a long-term basis by either:

- replacing the short-term debt with long-term debt (such as bonds payable) or with ownership securities (such as common stock); or
- extending, renewing, or replacing the short-term debt with other short-term obligations.

**FASB Statement No. 6** states that short-term obligations are excluded from a company’s current liabilities if two conditions are met: (1) it intends to refinance the obligation on a long-term basis, and (2) it has an ability to refinance. The **intent to refinance** on a long-term basis includes:

- **replacement** of short-term debt with long-term debt, such as bonds or notes payable;
- **extension** of short-term debt to a long-term period;
- **renewal** of short-term debt to a later maturity date;
- **conversion** of short-term debt to long-term debt;
- **amortization** of a note payable;
- **capitalization** of interest on a note payable;
- **repurchase** of a note payable with long-term debt;
- **issuance** of long-term debt with short-term debt.

**Questions:**

1. Describe the journal entries made by Baker Hughes in 2004 related to its remediation costs?
2. Does Baker Hughes accrue the remediation costs attributable to other PRPs who were unable to pay their share? Why or why not?
3. What is likelihood that Engelhard will incur a loss relating to the tax fraud, and what amount does Engelhard expect to pay?
4. Does the disclosure of the guarantee arrangements indicate that Whirlpool thinks it is probable that a loss will be incurred relating to these arrangements?

**Link to International Differences**

International accounting standards and U.S. accounting standards are similar in regard to contingencies, but there are some critical differences. International standards deal with loss contingencies but refer to them as provisions. A company is required to recognize a provision when it has a present obligation as a result of a past event, when it is probable that the company will have a future outflow of resources to settle the obligation, and when it can make a reliable estimate of the amount. These provisions are similar to U.S. GAAP but international standards use probable to mean that the outcome is more likely than not to occur, while U.S. standards use probable to mean the outcome is likely to occur (a more stringent test). Furthermore, in a situation where a company cannot determine whether the obligating event has occurred, international standards require recognition of a liability if it is probable that the event has occurred. International standards also require a company to measure the provision at the settlement price on the balance sheet date using present value techniques whenever the effect on the measurement of the liability is material. A company is not allowed to recognize gain contingencies until realized, but discloses a gain contingency in the notes to its financial statements if an inflow of economic benefits is probable.

**Other Liability Classification Issues**

We discuss two additional liability classification issues in this section: (1) short-term debt expected to be refinanced, and (2) classification of obligations that are callable by the creditor.
basis means that the company intends to refinance the short-term obligations so that it will not have to use working capital during the next year (or operating cycle, if longer). The ability to refinance on a long-term basis means that the company (1) has issued long-term obligations or equity securities after the date of its balance sheet but before it issues its balance sheet, or (2) has entered into a bona fide long-term financing agreement before it issues its balance sheet that clearly permits the company to refinance the short-term obligations on a long-term basis.

If a company actually has refinanced short-term debt after the year-end but before it issues its financial statements, it excludes an amount from the current liabilities shown on its year-end balance sheet. The amount excluded is only that portion of the short-term obligation that is equal to the proceeds from the new long-term obligations or equity securities issued to retire the short-term obligation. For example, assume that Rayvon Corporation, with $2,000,000 of short-term debt on December 31, 2007, issued 75,000 shares of common stock for $20 per share on January 9, 2008. The proceeds of $1,500,000 were scheduled to be used to retire the short-term obligation when it matured. On the December 31, 2007 balance sheet (issued on February 25, 2008), the company reports the short-term debt of $1,500,000 expected to be refinanced as a noncurrent liability. Note that the company reports the refinanced portion as a liability and not as stockholders’ equity since, as of year-end, the item was debt and not equity. It reports the other $500,000 as a current liability.

When a company relies on a financing agreement to show its ability to refinance, the amount of the short-term debt that it excludes from current liabilities is reduced to an amount that is the lesser of

1. The amount available for refinancing under the agreement, or
2. The amount obtainable under the agreement after considering the restrictions included in other agreements, or
3. A reasonable estimate of the minimum amount expected to be available for future refinancing if the amount that could be obtained fluctuates (for example, in relation to the company’s needs, in proportion to the value of the collateral, or according to other terms of the agreement).22

If the company cannot make a reasonable estimate, it must include the entire outstanding short-term obligation as a current liability.

When a company excludes a short-term obligation to be refinanced from its current liabilities, the notes to its financial statements must include a description of the financing agreement and the terms of any new debt, or equity securities issued or expected to be issued as a result of the refinancing. These obligations also may be shown in captions distinct from both the current liabilities and long-term debt, such as "Interim Debt" or "Short-Term Debt Expected to Be Refinanced."22

Repayment and Replacement

After the issuance of FASB Statement No. 6, an issue arose as to whether a company should exclude a short-term debt from its current liabilities if it repays the debt after the balance sheet date and then later issues long-term debt (or common stock) before the balance sheet actually is published. FASB Interpretation No. 8 concluded that a company must not exclude such short-term debt from its current liabilities at the balance sheet date.23 Thus, since the repayment of a short-term debt required the use of an existing actual current asset (even though it is later replaced), the company reports the short-term debt on its preceding year-end balance sheet as a current liability.

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22. "Classification of Short-Term Obligations Expected to Be Refinanced," FASB Statement of Financial Accounting Standards No. 6 (Stamford, Conn.: FASB, 1975), par. 9–12.
23. "Classification of a Short-Term Obligation Repaid Prior to Being Replaced by a Long-Term Security," FASB Interpretation No. 8 (Stamford, Conn.: FASB, 1976), par. 3.
Classification of Obligations That Are Callable by the Creditor

As we noted earlier in the chapter, a company generally reports the currently maturing portion of its long-term debt as a current liability. Also, FASB Statement No. 78 concluded that a company must report the entire amount of a long-term obligation as a current liability if the company is in violation of a long-term debt agreement (a requirement in the debt contract) at the balance sheet date, and the violation makes the liability callable by the creditor within one year (or operating cycle, if longer) from the balance sheet date.

An exception to this requirement is a callable obligation that meets the following conditions: (1) the creditor has waived the right to request repayment for more than one year (or operating cycle, if longer) from the balance sheet date, or (2) it is probable that the company will resolve the violation of a debt agreement for a long-term obligation within a specified grace period, thus preventing it from becoming callable. In this case, the company reports the obligation as long-term debt. It also discloses the circumstances involving an obligation under item (2) in the notes to its financial statements.24

The preceding GAAP indicate that the FASB concluded that a company’s current liability classification is intended to include obligations that are (or will be) due on demand within one year (or the operating cycle, if longer) from the balance sheet date, even though liquidation may not be expected within that period. As indicated by the italicized phrase, this concept does not conform to the requirement that a current liability is one that “a company expects to liquidate by using current assets...” Instead, it substitutes a rule that obligations are classified as current when they are legally callable within one year, whether or not they are likely to be called. In dissenting to FASB Statement No. 78, three Board members stated that:

It is asserted that this amendment will improve comparability. It will, in fact, cause situations to appear the same even when underlying facts and circumstances are sufficiently different to justify different reasonable expectations. This is not comparability; it is substituting an arbitrary rule for judgment.25

Secure Your Knowledge 13-3

- A contingency is an existing uncertainty as to possible gains or losses, where the uncertainty can only be resolved when a future event occurs or fails to occur.
- A loss contingency is accrued when it is probable that the future confirming event will occur and the amount of the loss can be reasonably estimated.
- If the future confirming event is not probable or cannot be reasonably estimated and there is a reasonable possibility of a loss, the loss contingency is disclosed in the notes to the financial statements.
- Certain loss contingencies that involve a guarantee (e.g., standby letters of credit, guarantees of indebtedness of others) are disclosed in the notes to the financial statements even though the possibility of a loss is remote.
- Gain contingencies are usually not accrued but are disclosed in the notes to the financial statements. Gain contingencies are generally recognized when realized.
- If a company has both the intent and ability to refinance short-term debt on a long-term basis, the debt is excluded from the company’s current liabilities.

25. Ibid., page 4.
Conceptually, a company should report its three main balance sheet elements—assets, liabilities, and equity—in homogeneous classes. This disclosure is helpful to users in assessing the nature, amount, timing, and liquidity of its resources and obligations. A company can report liabilities and assets as items in its balance sheet in various ways. The FASB has suggested broad guidelines as follows:

1. Assets and liabilities with different implications for the financial flexibility of the company should be reported as separate items.
2. Assets and liabilities with different general liquidity characteristics should be reported as separate items.
3. Assets and liabilities that differ regarding the attribute that is measured should be reported in separate categories.26

These guidelines suggest that a company should arrange its current liabilities in a way that will highlight their liquidity characteristics and their effect on its financial flexibility.

Most companies report current liabilities at the top of the Liabilities classification. Items within the current liability section typically may be listed (1) in the order of their average length of maturity, (2) according to amount (largest to smallest), or (3) in the order of liquidation preference—that is, in the order of their legal claims against assets. A popular way of presenting these items is as follows:

- Accounts payable
- Notes payable
- Accrued liability items
- Unearned revenue items
- Other current liabilities

A company includes any major issue affecting its current liabilities in a note to its financial statements. This presentation is made so that the notes and other supplemental information about current liabilities meet the requirement of full disclosure. For example, secured liabilities are clearly identified, along with the related assets pledged as collateral. If the due date of any liability can be extended, that fact and any related details are disclosed. Current liabilities are not offset against the assets that the company plans to use for their liquidation, and currently maturing long-term debt is classified as a current liability (unless refinanced).

Real Report 13-2 is an excerpt of the General Mills balance sheets showing how it reports its current liabilities, along with the related note to the financial statements. This disclosure is representative of the reporting techniques used by most large companies.

Real Report 13-2  Disclosure of Current Liabilities

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Liabilities (in part)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current Liabilities:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts payable</td>
<td>$1,145</td>
<td>$1,303</td>
</tr>
<tr>
<td>Current portion of long-term debt</td>
<td>233</td>
<td>105</td>
</tr>
<tr>
<td>Notes payable</td>
<td>583</td>
<td>1,236</td>
</tr>
<tr>
<td>Other current liabilities</td>
<td>796</td>
<td>800</td>
</tr>
<tr>
<td>Total Current Liabilities</td>
<td>$2,757</td>
<td>$3,444</td>
</tr>
</tbody>
</table>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (in part):

5. BALANCE SHEET INFORMATION (in part)
The components of certain balance sheet accounts are as follows:

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Other Current Liabilities:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accrued payroll</td>
<td>$ 230</td>
<td>$ 243</td>
</tr>
<tr>
<td>Accrued interest</td>
<td>186</td>
<td>178</td>
</tr>
<tr>
<td>Accrued taxes</td>
<td>249</td>
<td>129</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>131</td>
<td>250</td>
</tr>
<tr>
<td>Total other current liabilities</td>
<td>$ 796</td>
<td>$ 800</td>
</tr>
</tbody>
</table>

8. DEBT (in part)

NOTES PAYABLE – The components of notes payable and their repsective weighted average interest rates at the end of the periods were as follows:

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Weighted Average</td>
<td>Notes Payable</td>
<td>Interest Rate</td>
</tr>
<tr>
<td>U.S. commercial</td>
<td>$ 441</td>
<td>1.2%</td>
</tr>
<tr>
<td>paper</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Canadian commercial paper</td>
<td>159</td>
<td>2.1</td>
</tr>
<tr>
<td>Euro commercial</td>
<td>499</td>
<td>2.1</td>
</tr>
<tr>
<td>paper</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Financial institutions</td>
<td>234</td>
<td>6.7</td>
</tr>
<tr>
<td>Amounts reclassified to long-term debt</td>
<td>(750)</td>
<td>–</td>
</tr>
<tr>
<td>Total Notes Payable</td>
<td>$ 583</td>
<td>$ 1,236</td>
</tr>
</tbody>
</table>

See Note Seven for a description of related interest-rate derivative instruments.

To ensure availability of funds, we maintain bank credit lines sufficient to cover our outstanding short-term borrowings. As of May 30, 2004, we had $1.85 billion in committed lines and $264 million in uncommitted lines.

In the third quarter of fiscal 2004, we entered into an agreement for a new $750 million credit facility, expiring in January 2009. That facility replaced a $1.1 billion, 364-day facility, which expired January 22, 2004. The new credit facility, along with our existing $1.1 billion multi-year facility that expires January 2006, brings our total committed back-up credit amount to $1.85 billion. These revolving credit agreements provide us with the ability to refinance short-term borrowings on a long-term basis; accordingly, a portion of our notes payable has been reclassified to long-term debt.

Questions:

1. What must the revolving credit agreement include so that General Mills can reclassify a portion of its notes payable as long-term debt?
2. If current assets were $3,215 million on May 30, 2004, compute the current ratio.
3. If cost of goods sold was $6,584 million on May 30, 2004, compute the payables turnover.
At the beginning of the chapter, we identified several objectives you would accomplish after reading the chapter. The objectives are listed below, each followed by a brief summary of the key points in the chapter discussion.

1. **Explain the characteristics of a liability.** The characteristics of a liability are: (1) a present responsibility for the probable future transfer or use of assets, (2) the obligation cannot be avoided, and (3) the liability transaction has already occurred.

2. **Define current liabilities.** Current liabilities are obligations that are expected to require the use of current assets or the creation of current liabilities within one year or the normal operating cycle, whichever is longer.

3. **Account for compensated absences.** Compensated absences include vacation, holiday, illness, or other personal activities for which an employee is paid. A company records an expense and a liability for an employee’s compensation for future absences when: (1) its obligation relates to employee’s services already rendered, (2) the obligation relates to rights that vest or accumulate, (3) payment is probable, and (4) it can estimate the amount.

4. **Understand and record payroll taxes and deductions.** Payroll taxes include social security taxes (F.I.C.A. taxes, including O.A.S.D.I and Medicare) levied on both the employee and employer, as well as unemployment taxes (F.U.T.A. and state) levied only on the employer. Payroll deductions include income tax withholdings and items such as union dues. A company records these items as liabilities at the time it records salaries expense and payroll tax expense.

5. **Record property taxes.** A company records property taxes in equal monthly amounts during the fiscal period of the taxing authority for which the taxes are levied. By doing so, at the end of the company’s accounting period it reports the appropriate accrual or prepayment.

6. **Account for warranty costs.** Under the expense warranty accrual method, a company recognizes in the period of sale the estimated warranty expense and a liability for future performance. Under the sales warranty accrual method, a company separates the accounting for the product sale from the accounting for the (implied) warranty contract. Under the modified cash basis method, a company records the warranty cost as an expense during the period that repairs are made.

7. **Explain the terms “probable,” “reasonably possible,” and “remote” related to contingencies.** “Probable” means the future event is likely to occur. “Reasonably possible” means that the chance of the future event occurring is more than remote but less than likely. “Remote” means that the chance of the future event occurring is slight.

8. **Record and report a loss contingency.** A loss contingency is recognized if the future event is probable and if its amount can be reasonably estimated. If these two criteria are met, a company records a loss contingency by debiting an expense (or loss) and crediting a liability (or contra asset). Otherwise, it discloses a loss contingency in the notes to its financial statements.

9. **Disclose a gain contingency.** A gain contingency is usually not accrued; a company discloses a gain contingency in the notes to its financial statements. A company generally recognizes a gain contingency when it is realized.

### Answers to Real Report Questions

#### Real Report 13-1 Answers

1. Baker Hughes makes a journal entry that debits an expense account and credits a liability account for its share of expected environmental remediation costs. As the remediation costs are paid, Baker Hughes reduces the liability account. For 2004, the liability account decreased by $700,000 ($4.3 million less $3.6 million), indicating that the net remediation costs paid in 2004 exceeded the accruals for 2004.

2. Under the concept of joint and several liability, Baker Hughes may be liable for remediation costs attributable to other PRPs. However, where its involvement is minor, Baker Hughes believes there is a remote chance that it would be held responsible for costs in excess of its share, and no liability is accrued for these excess costs. Where it is considered a major PRP, Baker Hughes accurses its share of remediation costs as well as the estimate of the remediation costs of other PRPs that are not expected to be able to pay their share.

3. Although Engelhard’s note disclosure states that no evidence of tax fraud by company officials has been found, the fact that Engelhard accrued this liability indicates that the company thinks it is probable it will have a loss of $30 million, its reasonable estimate of the liability. While Engelhard discloses the $30 million as the maximum amount it expects to pay, the disclosure suggests a range of possible outcomes. It should be noted that, if a range of outcomes is likely, GAAP requires a company to accrue the most likely estimate within the range. If all amounts in the range are equally likely, GAAP requires the minimum amount within the range to be accrued. Therefore, the user of the financial statement should not interpret this disclosure as stating that Engelhard expects to settle the amount for less than the $30 million that is accrued.

4. Whirlpool’s disclosure does not indicate that a future loss is probable. Certain loss contingencies, such as guarantees of indebtedness of others, are disclosed in the notes to the financial statements even when the possibility of loss is remote.
**Multiple Choice (AICPA Adapted)**

Select the best answer for each of the following.

**M13-1** Which of the following is classified as an accrued payroll liability?

<table>
<thead>
<tr>
<th></th>
<th><strong>Federal Income Tax Withheld</strong></th>
<th><strong>Employee’s Share of F.I.C.A. Taxes</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>a</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>b</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>c</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>d</td>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

**Real Report 13-2 Answers**

1. In order to reclassify a portion of its notes payable as long-term debt, the revolving credit agreement must clearly permit the company to refinance the portion of the notes payable reclassified after considering any restrictions.

2. The current ratio for General Mills at May 30, 2004 is 1.17 ($3,215 million / $2,757 million).

3. The payables turnover ratio for General Mills at May 30, 2004 is 5.38 ($6,584 million / {[$1,145 million / $1,303 million] / 2}].

**Questions**

**Q13-1** Define **liabilities**. Explain the meanings of **probable** and **obligations** in the context of a liability.

**Q13-2** Distinguish between a legal and a nonlegal (accounting) liability. Give an example of each.

**Q13-3** List the three characteristics of a liability. Discuss briefly.

**Q13-4** Before a liability can be reported, a company must know the identity of the recipient. True or false? Justify your answer.

**Q13-5** What are the primary issues in accounting for current liabilities?

**Q13-6** Define a company’s operating cycle.

**Q13-7** Why is the liquidity of liabilities important in the accounting for liabilities?

**Q13-8** How does the constraint of materiality affect the accounting for current liabilities?

**Q13-9** Define a non-interest-bearing note that is discounted at a bank at a specific rate. How are the proceeds computed for a non-interest-bearing note?

**Q13-10** What are compensated absences? How does a company account for them?

**Q13-11** *FASB Statement No. 49* requires that a company selling inventory and agreeing to repurchase it later neither record the transaction as a sale nor remove the inventory from the balance sheet. If so, does a new current liability arise? How is its amount measured?

**Q13-12** Identify how to account for warranty costs under the expense warranty accrual method, sales warranty accrual method, and modified cash basis.

**Q13-13** Define **contingency**. What exactly is the company uncertain about—whether a future event will take place and result in a liability, or whether a future event will take place that will confirm that a liability exists from an event that has already taken place?

**Q13-14** How do the matching principle and the conservatism convention enter into the accounting for contingencies?

**Q13-15** What two criteria must be met before a loss contingency is reported in a company’s financial statements?

**Q13-16** With regard to a loss contingency, by what date must the event that results in a probable loss have occurred before accrual is required? By what date must information be available for a company to assess the probability that a loss has been incurred?

**Q13-17** What conditions would have to be met for a company to accrue the loss from an unfiled lawsuit?

**Q13-18** Define **gain contingency**. Describe the accounting requirements for a gain contingency.

**Q13-19** What two criteria must be met before a company can classify short-term debt that is expected to be refinanced as a noncurrent liability?

**Q13-20** How does a company demonstrate the ability to refinance currently maturing short-term debt?

**Q13-21** *FASB Statement No. 78* requires that a company report certain obligations due on demand within one year (or operating cycle, if longer) as current liabilities. Do you agree with this statement? Explain.
M13-2 During 2007 Lawton Company introduced a new line of machines that carry a three-year warranty against manufacturer’s defects. Based on industry experience, warranty costs are estimated at 2% of sales in the year of sale, 4% in the year after sale, and 6% in the second year after sale. Sales and actual warranty expenditures for the first three-year period were as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Sales</th>
<th>Actual Warranty Expenditures</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>$200,000</td>
<td>$3,000</td>
</tr>
<tr>
<td>2008</td>
<td>$500,000</td>
<td>$15,000</td>
</tr>
<tr>
<td>2009</td>
<td>$700,000</td>
<td>$45,000</td>
</tr>
<tr>
<td></td>
<td>$1,400,000</td>
<td>$63,000</td>
</tr>
</tbody>
</table>

What amount should Lawton report as a liability at December 31, 2009?

- a. $0
- b. $5,000
- c. $68,000
- d. $105,000

M13-3 How should a loss contingency that is reasonably possible and for which the amount can be reasonably estimated be reported?

<table>
<thead>
<tr>
<th>Accrued</th>
<th>Disclosed</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

M13-4 All of Rolf Co.’s employees are entitled to two weeks of paid vacation for each full year in Rolf’s employ. Unused vacation time can be accumulated and carried forward to succeeding years and will be compensated at the salary in effect when the vacation is taken. Mary Beal started her employment with Rolf on January 1, 2001. As of December 31, 2007, when Beal’s salary was $500 per week, Beal had used 10 weeks of her accumulated vacation time. In December 2007 Beal notified Rolf of her intention to use her accumulated vacation weeks in June 2008. Rolf regularly scheduled salary adjustments in July of each year. Rolf properly did not deduct compensation for unused vacations in Rolf’s 2007 income tax return. How much should Rolf report as a liability at December 31, 2007 for Beal’s accumulated vacation time?

- a. $0
- b. $500
- c. $1,000
- d. $2,000

M13-5 Bronson Apparel, Inc., operates a retail store and must determine the proper December 31, 2007 year-end accrual for the following expenses:

- The store lease calls for fixed rent of $1,000 per month, payable at the beginning of the month, and additional rent equal to 6% of net sales over $200,000 per calendar year, payable on January 31 of the following year. Net sales for 2007 are $800,000.

- Bronson has personal property subject to a city property tax. The city’s fiscal year runs from July 1 to June 30 and the tax, assessed at 3% of personal property on hand at April 30, is payable on June 30. Bronson estimates that its personal property tax will amount to $6,000 for the city’s fiscal year ending June 30, 2008.

In its December 31, 2007 balance sheet, Bronson should report accrued expenses of

- a. $39,000
- b. $39,600
- c. $51,000
- d. $51,600

M13-6 When a company receives a deposit from a customer to protect itself against nonpayment for future services, the deposit should be classified by the company as

- a. Revenue
- b. A liability
- c. Part of the allowance for doubtful accounts
- d. A deferred credit deducted from accounts receivable

M13-7 The balance in Ashwood Company’s Accounts Payable account at December 31, 2007 was $900,000 before any necessary year-end adjustment relating to the following:

- Goods were in transit from a vendor to Ashwood on December 31, 2007. The invoice cost was $50,000, and the goods were shipped FOB shipping point on December 29, 2007. The goods were received on January 2, 2008.

- Goods shipped FOB shipping point on December 19, 2007 from a vendor to Ashwood were lost in transit. The invoice cost was $25,000. On January 5, 2008 Ashwood filed a $25,000 claim against the common carrier.

- Goods shipped FOB destination on December 22, 2007 from a vendor to Ashwood were received on January 6, 2008.

What amount should Ashwood report as accounts payable on its December 31, 2007 balance sheet?

- a. $925,000
- b. $940,000
- c. $950,000
- d. $975,000

M13-8 On September 1, 2007 a company borrowed cash and signed a one-year, interest-bearing note on which both the principal and interest are payable on September 1, 2008. How will the note payable and the related interest be classified in the December 31, 2007 balance sheet?

- a. Current liability
- b. Noncurrent liability
- c. Current liability
- d. Noncurrent liability

M13-9 Morgan Company determined that (1) it has a material obligation relating to employees’ rights to receive compensation for future absences attributable to employees’ services already rendered, (2) the obligation relates to rights that vest, and (3) payment of the compensation is probable. The amount of Morgan’s obligation as of December 31, 2007 is reasonably estimated for the following employee benefits:

<table>
<thead>
<tr>
<th>Note Payable</th>
<th>Accrued Interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Current liability</td>
<td>Noncurrent liability</td>
</tr>
<tr>
<td>b. Noncurrent liability</td>
<td>Current liability</td>
</tr>
<tr>
<td>c. Current liability</td>
<td>Current liability</td>
</tr>
<tr>
<td>d. Noncurrent liability</td>
<td>No entry</td>
</tr>
</tbody>
</table>

What total amount should Morgan report as its liability for compensated absences in its December 31, 2007 balance sheet?

- a. $0
- b. $25,000
- c. $100,000
- d. $125,000
E13-1  Accounts Payable and Cash Discounts  On January 4, 2007 Dunbar Company purchased, on credit, 2,000 television sets at $500 each. Terms of the purchase were 2/10, n/30. Dunbar paid for one-fifth of these sets within 10 days and the remaining four-fifths by January 31.

Required
Prepare the journal entries on Dunbar Company’s books, assuming that it uses the net price method to record its merchandise. (Dunbar uses a perpetual inventory system.)

E13-2  Notes Payable  On December 1, 2007 Insto Photo Company purchased merchandise, invoice price $25,000, and issued a 12%, 120-day note to Ringo Chemicals Company. Insto uses the calendar year as its fiscal year and uses the perpetual inventory system.

Required
Prepare journal entries on Insto Photo’s books to record the preceding information, including the adjusting entry at the end of the year and payment of the note at maturity.

E13-3  Non-interest-bearing Notes Payable  On November 16, 2007 the Clear Glass Company borrowed $20,000 from First American Bank by issuing a 90-day, non-interest-bearing note. The bank discounted this note at 12% and remitted to Clear Glass Company the difference.

Required
1. Prepare the journal entries of Clear Glass to record the preceding information, the related calendar year-end adjusting entry, and payment of the note at maturity.
2. Show how the preceding items would be reported on the December 31, 2007 balance sheet.
3. What is Clear Glass Company’s effective interest rate?

E13-4  Discounting of Notes Payable  On October 30, 2007 the Sanchez Company acquired a piece of machinery and signed a 12-month note for $24,000. The face value of the note includes the price of the machinery and interest. The note is to be paid in four $6,000 quarterly installments. The value of the machinery is the present value of the four quarterly payments discounted at an annual interest rate of 16%.

Required
1. Prepare all the journal entries required to record the preceding information including the year-end adjusting entry and the installment payments. Present value techniques should be used.
2. Show how the preceding items would be reported on the December 31, 2007 balance sheet.

E13-5  Compensated Absences  The Bettinghaus Corporation began business on January 2, 2007 with five employees. It created a sick leave and vacation policy stated as follows: Each employee is allowed eight days of paid sick leave each year and one day of paid vacation leave for each month worked. The accrued vacation leave cannot be taken until the employee has been with the company one year. The sick leave, if not used, accumulates to an 18-day maximum. The vacation leave accumulates for five years, but at any time the employee may request additional compensation in lieu of taking paid vacation leave. The company considers that the requirements of FASB Statement No. 43 have been met and desires to record the liability for both compensated absences on a quarterly basis. The daily gross wages for each employee are $160.

Required
1. Prepare journal entries to record the liability for compensated absences for the first quarter of 2007. Assume no sick leave had been taken by the employees.
2. Prepare a partial interim balance sheet showing how the liability created in Requirement 1 would be reported on March 31, 2007.
E13-6 **Sales Taxes** During August the Hill Sales Company had these summary transactions:
1. Cash sales of $210,000, subject to sales taxes of 6%
2. Sales on account of $260,000, subject to sales taxes of 6%
3. Paid the sales taxes to the state

**Required**
Prepare journal entries to record the preceding transactions.

E13-7 **Payroll and Payroll Taxes** The payroll of the Rand Company on December 31 of the current year is as follows:
1. Total payroll, $500,000
2. Payroll in excess of $90,000 to each employee, $350,000
3. Payroll in excess of $7,000 to each employee, $400,000
4. Income taxes withheld, $85,000
5. Union dues withheld, $10,000
6. Tax rates: State unemployment tax, 5.4%; F.I.C.A. tax, 8% for both employees and employers; federal unemployment tax, 0.8%; 1% merit-rating reduction of state unemployment tax from normal rate of 5.4%

**Required**
Prepare the journal entries for Rand’s payroll and payroll taxes.

E13-8 **Bonus Obligation** Raymond Moss, vice president of Moss Auto Parts, gets an annual bonus of 15% of net income after bonus and income taxes. Income before bonus and income taxes is $250,000. The effective income tax rate is 30%.

**Required**
1. Compute the amount of Raymond Moss’s bonus.
2. Compute the income tax expense.

E13-9 **Property Taxes** Family Practice Associates has an estimated property tax liability of $7,200 assessed as of January 1, 2007 for the year May 1, 2007 to April 30, 2008. The property tax is paid on September 1, 2007. The property tax becomes a lien against the property on May 1.

**Required**
Prepare the necessary monthly journal entries to record the preceding information for the period from May 1 to September 30, 2007 (assuming actual taxes are the same as estimated). What would be the amount of the liability on December 31, 2007?

E13-10 **Property Taxes** The Ames Company is located in a city and county that issue property tax statements in May of each year. The fiscal year for the two local governmental units is May 1 to April 30. Property taxes of $48,000 are assessed against the Ames Company property held on January 1, 2007. The taxes become a lien against Ames Company property on May 1, 2007. The actual amount of the property taxes of $48,000 is determinable on May 1, 2007; therefore, no estimate of taxes is required. The tax bills are payable in two equal installments on July 10 and September 10.

**Required**
Assuming that monthly accruals are recorded, prepare all property tax journal entries for the period May 1 to September 30, 2007.

E13-11 **Expense Warranty Accrual Method** On September 1, 2007 Carolina Electronics Company has ready for sale 1,000 CD players. On October 1, 2007, 900 are sold at $50 each with a one-year warranty. Carolina estimates that the warranty cost on each CD player sold will probably average $2 per unit. During the final three months of 2007, Carolina incurred warranty costs of $800, and in 2008 warranty costs were $1,000.

**Required**
1. Prepare the journal entries for the preceding transactions, using the expense warranty accrual method.
2. Show how the preceding items would be reported on the December 31, 2007 balance sheet.

E13-12 **Sales Warranty Accrual Method** On August 1, 2007 Pereira Corporation has ready for sale 2,000 Wiglow instruments. During the next 5 months, 1,600 Wiglows are sold at $460 each with a one-year warranty. Pereira estimates that the warranty cost on each Wiglow sold will probably average $10 per unit. In this period, Pereira incurred warranty costs of $9,200. Costs for 2008 were $7,000.

**Required**
1. Prepare the journal entries for the preceding transactions, using the sales warranty accrual method.
2. Show how the items would be reported on the December 31, 2007 balance sheet.

E13-13 **Premium Obligation** The Sweet Dates Company offers to its customers a premium—a glass bowl (cost to Sweet Dates, $0.90) upon return of 40 coupons. Two coupons are placed in each box of dates sold. The company estimates, on the basis of past experience, that only 70% of the coupons will ever be redeemed. During 2007, 10 million boxes of dates are sold at $0.30 each. Eight million coupons are redeemed during 2007. Sweet Dates purchased 360,000 glass bowls for the plan in 2007.
Required
1. Prepare the journal entries related to the sales of dates and the premium plan in 2007.
2. Show how the preceding items would be reported on the December 31, 2007 balance sheet.

E13-14 Premium Obligation On the back of its cereal boxes, the Tiger Cereal Company offers a premium to its customers. The premium, a toy truck, may be claimed by sending in $1 plus 10 coupons; one coupon is included in each box of cereal sold. The company estimates, based on past experience, that 60% of the coupons will be redeemed. During 2007, the company purchased 240,000 toy trucks at $1.25 each for the premium promotion and sold 5,000,000 boxes of cereal at $1.80 per box. In 2007, 2,200,000 coupons were redeemed.

Required
1. Prepare the journal entries related to the previous promotion (including sales) for 2007.
2. Show how the items related to the premium plan would be reported on the December 31, 2007 balance sheet.

E13-15 Gift Certificates On December 5, 2007 Super Circuit Store sold gift certificates totaling $4,000. By December 31, 2007 all but $750 worth of these certificates had been redeemed for merchandise. Outstanding certificates were then redeemed by January 15, 2008.

Required
1. Prepare journal entries on Super Circuit Store’s books to reflect the preceding transactions.
2. How would the gift certificates be reported on Super Circuit’s balance sheet on December 31, 2007?

E13-16 Loss Contingency On December 4, 2007 Dan Johnson, delivery truck driver for Farmers Products, Inc., ran a stop sign and collided with another vehicle. On January 8, 2008 the driver of the other vehicle filed suit against Farmers Products for damages to the vehicle. Estimated damages to this vehicle were $6,500. The dairy issued its 2007 financial statements on March 3, 2008.

Required
Prepare the disclosures and/or journal entries Farmers Products should make in preparing its December 31, 2007 financial statements.

E13-17 Gain Contingency On December 31, 2007 Braino Tech., Inc. learned that its competitor had introduced a product making use of an accessory over which Braino Tech. has exclusive patent rights. Braino Tech. planned to file suit and in all likelihood, its attorneys felt, Braino should recover at least $500,000. Braino Tech.’s December 31, 2007 year-end financial statements were issued March 2, 2008. At that date Braino Tech. still planned to file suit, even though it had not yet done so.

Required
Discuss the accounting treatment in regard to the 2007 financial statements of Braino Tech. called for by FASB Statement No. 5 concerning the described circumstances.

E13-18 Disclosure of Serial Bonds Payable On May 1, 2007 the Ramden Company issues 13% serial bonds with a face value of $2 million. The bond contract calls for retirement of the bonds in periodic installments of $200,000, starting on May 1, 2008 and continuing on each May 1 thereafter until all bonds are retired.

Required
How would the preceding information appear in the Ramden Company’s balance sheets on December 31, 2007 and 2008?

E13-19 Short-Term Debt Expected to Be Refinanced On December 31, 2007 Excello Electric Company had $1 million of short-term notes payable due February 7, 2008. Excello expected to refinance these notes on a long-term basis. On January 15, 2008 the company issued bonds with a face value of $900,000 at 98; brokerage fees and other costs of issuance were $3,450. On January 22, 2008 the proceeds from the bond issue plus additional cash held by the company on December 31, 2007 were used to liquidate the $1 million of short-term notes. The December 31, 2007 balance sheet is issued on February 12, 2008.

Required
Prepare a partial balance sheet as of December 31, 2007 showing how the $1 million of short-term notes payable should be disclosed. Include an appropriate footnote for proper disclosure.

E13-20 Short-Term Debt Expected to Be Refinanced On December 31, 2007 Carrboro Textile Company had short-term debt in the form of notes payable totaling $600,000. These notes were due on June 1, 2008. Carrboro expected to refinance these notes on a long-term basis. On February 1, 2008 Carrboro entered into an agreement with Worldwide Life Insurance Company whereby Worldwide will lend Carrboro $450,000, payable in five years at 12%. The money will be available to Carrboro on May 20, 2008. Carrboro issues its December 31, 2007 year-end financial statements on March 2, 2008.

Required
Show how the $600,000 notes payable will be classified on Carrboro Textile Company’s balance sheet on December 31, 2007.
PROBLEMS

P13-1  Accounts Payable and Cash Discounts  The Byrd Company had the following transactions during 2007 and 2008:
1. On December 24, 2007 a computer was purchased on account from Computers International for $60,000. Terms of the sale were 2/10, n/30.
2. Byrd calculated that to forgo the discount for the computer would be the equivalent of paying 36% interest annually on the $58,800 for the extra 20 days. Therefore, Byrd went to First Local Bank and signed a $60,000, 30-day note at 12% in order to take advantage of the discount terms. This transaction took place on December 29, 2007. (The account payable was paid on January 2, 2008 and the note was paid at maturity.)
3. On December 30, 2007, Byrd declared a $2.00 cash dividend to the common stockholders. Ten thousand shares were outstanding on this date. The dividend is to be paid on January 5, 2008.

Required
1. Prepare the journal entries for the Byrd Company for both 2007 and 2008. Assume that the net price method is used to account for the credit terms.
2. Show how the preceding items would be reported in the current liabilities section of Byrd’s December 31, 2007 balance sheet.
3. Assuming Byrd’s current assets were $1,200,000 and its current ratio was 2.4 at the end of 2006, compute the current ratio at the end of 2007 (based solely on the effects of the preceding transactions).

P13-2  Notes Payable and Effective Interest  On November 1, 2007 Edwin, Inc., borrowed cash and signed a $60,000, one-year note payable.

Required
1. Compute the following items assuming (i) an interest-bearing note at 12%, (ii) a non-interest-bearing note discounted at 12%:
   a. Cash received
   b. Effective interest rate
   c. Interest expense for 2007

P13-3  Trade Note Transactions  The Adjusto Corporation (which is on a December 31 fiscal year-end) engaged in the following transactions during 2007 and 2008:

2007
   Nov. 1 Issued a 120-day, 12% note, face value of $15,000, to Johnson Company to settle an open account of that amount
   Dec. 1 Issued a 90-day, 12% note, face value of $22,000, to Winslow Corporation for the purchase of merchandise (the perpetual inventory method is used)

2008
   Mar. 1 Paid the principal and interest on both the Johnson and the Winslow notes

Required
Prepare journal entries to record the preceding transactions on Adjusto’s books, including the adjusting entries at the end of 2007.

P13-4  Compensated Absences  The Rexallo Company begins business on January 2, 2007 with 15 employees. Its company policy is to permit each employee to take six days of paid sick leave each year and one and one half days of paid vacation leave for each month worked. The accrued vacation leave cannot be taken until the employee has been with the company nine months. The sick leave, if not used, accumulates to a 24-day maximum. The vacation leave accumulates for two years, but at any time after a one-year period the employee may request additional compensation in lieu of taking paid vacation leave. The company desires to record the liability for compensated absences on a quarterly basis. Assume that the gross wages for each employee are $100 per day.

The following selected events take place during the first two quarters of 2007:
1. On March 31, 2007 the quarterly liability for compensated absences is to be recorded.
2. On April 30, 2007 the following $45,000 monthly payroll, including paid vacation and sick leave, is summarized from the records of Rexallo:

<table>
<thead>
<tr>
<th>Payroll for</th>
<th>Time Worked</th>
<th>Vacation Taken</th>
<th>Sick Leave Taken</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salaries</td>
<td>$42,000</td>
<td>$1,800</td>
<td>$1,200</td>
</tr>
</tbody>
</table>

3. On June 30, 2007 the quarterly liability for compensated absences is to be recorded.
Required
1. Prepare journal entries to record the preceding events, ignoring payroll taxes and assuming that both sick leave and vacation time meet the requirements of FASB Statement No. 43 for accrual.
2. Prepare a partial interim balance sheet as of March 31, 2007 to disclose the liability created in Requirement 1.

P13-5 Sales Taxes The Mauldin Company makes sales on which a 5% sales tax is assessed. The following summary transactions were made during 2007:
1. Sales for cash of $1,665,400, excluding sales taxes
2. Sales on credit of $2,820,500, excluding sales taxes
3. Sales taxes of $168,220 were paid to the state government during 2007

Required
1. Prepare journal entries to record the preceding transactions.
2. Show how the unpaid sales taxes would be reported on the December 31, 2007 balance sheet of Mauldin.

P13-6 Payroll and Payroll Taxes Bailey Dry Cleaners has six employees who were paid the following wages during 2007:

<table>
<thead>
<tr>
<th>Name</th>
<th>Wages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Frank Johnson</td>
<td>$ 27,000</td>
</tr>
<tr>
<td>Bill Long</td>
<td>18,000</td>
</tr>
<tr>
<td>Duff Morse</td>
<td>95,000</td>
</tr>
<tr>
<td>Laura Stewart</td>
<td>28,000</td>
</tr>
<tr>
<td>Cindy Sharpe</td>
<td>26,000</td>
</tr>
<tr>
<td>Melissa Ledbetter</td>
<td>20,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$214,000</strong></td>
</tr>
</tbody>
</table>

The state allows the company a 1% unemployment compensation merit-rating reduction from the normal rate of 5.4%. The federal unemployment rate is 0.8%. The maximum unemployment wages per employee are $7,000 for both the state and the federal government. Income tax withholdings of 20% are applied to all employees. An 8% F.I.C.A. tax for both employees and employers is applied to the first $90,000 of each employee’s wages.

Required
1. Calculate the amount of payroll taxes to be paid by Bailey.
2. Prepare the journal entries to record the payment of payroll and the payroll tax expense.

P13-7 Bonus Obligation and Income Tax Expense James Kimberley, president of National Motors, receives a bonus of 10% of National’s profits after his bonus and the corporation’s income taxes are deducted. National’s effective income tax rate is 30%. Profits before income taxes and his bonus are $5,000,000 for 2007.

Required
1. Compute the amount of Kimberley’s bonus for 2007.
3. Prepare journal entries at the end of 2007 to record the bonus and income taxes.
4. Show how the bonus and income taxes would be reported on National Motors’ December 31, 2007 balance sheet.

P13-8 Property Taxes The Rosen Corporation was formed on December 12, 2006. It plans to close its books annually each December 31. The corporation is located in Larzamik City and Apple County. The fiscal period of these two governmental units runs from July 1 to June 30. The property tax that they assess on property held on January 1 of each year becomes a lien against the property on July 1. The estimated property taxes for Rosen Corporation for the period July 1, 2007 to June 30, 2008 are $15,300. The tax bill is mailed in October with a requirement that the tax be paid before December 31. The tax bill received on October 30, 2007 for the Rosen Corporation revealed an actual tax of $15,680, and the corporation paid this amount on November 30, 2007. The corporation elects to record monthly property tax adjustments for interim statements required by management.

Required
2. Show how the preceding information would be reported on the December 31, 2007 balance sheet of Rosen Corporation.

P13-9 Expense Warranty Accrual Method Clean-All, Inc., sells washing machines with a three-year warranty. In the past Clean-All has found that in the year after sale, warranty costs have been 3% of sales; in the second year after sale, 5% of sales; and in the third year after sale, 7% of sales. The following data are also available:

<table>
<thead>
<tr>
<th>Year</th>
<th>Sales</th>
<th>Warranty Expenditures</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>$500,000</td>
<td>$62,000</td>
</tr>
<tr>
<td>2008</td>
<td>650,000</td>
<td>82,000</td>
</tr>
<tr>
<td>2009</td>
<td>700,000</td>
<td>85,000</td>
</tr>
</tbody>
</table>
Required
1. Prepare the journal entries for the preceding transactions for 2007–2009, using the expense warranty accrual method. Closing entries are not required.
2. What amount would Clean-All report as a liability on its December 31, 2009 balance sheet, assuming the liability had a balance of $88,200 on December 31, 2006?

P13-10 Sales Warranty Accrual Method Wright Machinery Corporation manufactures automobile engines for major automobile producers. These engines have a warranty against any defects for a period of five years. Even though Wright Machinery does not have a separate warranty contract, it assumes that the $993 selling price of each engine includes an implied service contract of $73 per engine. During 2007 Wright Machinery sold 8,000 engines to National Motors. During 2007 Wright Machinery repaired defective motors at a cost of $94,400.

Required
Prepare the journal entries for the preceding transactions, assuming that Wright Machinery uses the sales warranty accrual method to account for warranties.

P13-11 Premium Obligation Yummy Cereal Company is offering one toy shovel set for 15 box tops of its cereal. Year-to-date sales have been off, and it is hoped that this offer will stimulate demand. Each shovel set costs the company $3. The following data are available for the last three months of 2007:

<table>
<thead>
<tr>
<th>Month</th>
<th>Boxes of Cereal Sold</th>
<th>Shovel Sets Purchased by the Company</th>
<th>Box Tops Redeemed by Customers</th>
</tr>
</thead>
<tbody>
<tr>
<td>October</td>
<td>21,000</td>
<td>880</td>
<td>12,000</td>
</tr>
<tr>
<td>November</td>
<td>24,000</td>
<td>1,083</td>
<td>16,005</td>
</tr>
<tr>
<td>December</td>
<td>33,000</td>
<td>1,697</td>
<td>20,745</td>
</tr>
</tbody>
</table>

It is estimated that only 70% of the box tops will be redeemed. The cereal sells for $2.80 per box.

Required
1. Prepare journal entries for each month to record sales, shovel set purchases, redemptions, and closing entries, assuming that the books are closed at the end of each month.
2. Assuming Yummy prepares monthly financial statements, indicate how the premiums and the estimated liability would be disclosed on Yummy’s ending balance sheets for October, November, and December.

P13-12 Contingencies Fallon Company, a toy manufacturer that also operates several retail outlets, is preparing its December 31, 2007 financial statements. It has identified the following legal situations that may qualify as contingencies:

1. A customer is suing the company for $800,000 in damages because her child was injured in November 2007 while riding an escalator that stopped suddenly in one of its stores. The child was hurt when he tripped and fell while walking “down” an escalator that was going “up.” Legal counsel feels that the child is partially at fault, but that it is probable that the lawsuit will be settled for between $50,000 and $100,000, with $80,000 being the most likely amount.
2. The company has discovered that a skateboard it began manufacturing and selling in 2007 has defective bearings, sometimes causing a wheel to fall off. The company has issued a “recall” notice in newspapers and magazines in which it offers to replace the bearings. It estimates a cost of $200,000 for these repairs. No lawsuits have been filed for injury claims, although the company feels that there is a reasonable possibility that claims may total as high as $2 million.
3. The company has an incinerator behind one of its retail outlets which is used to burn cardboard boxes received in shipments of inventory from suppliers. The state environmental protection agency filed suit against the company in August 2007 for air pollution. The company expects to stop using the incinerator and begin recycling. However, its lawyers believe that it is probable that a fine of between $40,000 and $100,000, with $80,000 being the most likely amount.
4. In early 2007 the company signed a contract with a computer vendor to install “state of the art” cash registers in all of its retail outlets. Because of the vendor’s inability to acquire sufficient cash registers, the vendor canceled the contract. The company has filed a breach of contract suit against the vendor, claiming $300,000 in damages. The company’s lawyers expect that it will settle the suit “out of court” for $150,000.

Required
For each situation, prepare the journal entry (if any) on December 31, 2007 to record the information for Fallon Company, and explain your reasoning. If no journal entry is recorded, explain how the information would be disclosed in Fallon Company’s 2007 annual report.
Greenlaw, Inc., a publishing company, is preparing its December 31, 2007 financial statements and must determine the proper accounting treatment for each of the following situations:

1. Greenlaw sells subscriptions to several magazines for a one-year, two-year, or three-year period. Cash receipts from subscribers are credited to magazine subscriptions collected in advance, and this account had a balance of $2,500,000 at December 31, 2007. Outstanding subscriptions at December 31, 2007 expire as follows:

   During 2008 — $600,000
   During 2009 — 900,000
   During 2010 — 400,000

2. On January 3, 2007 Greenlaw discontinued collision, fire, and theft coverage on its delivery vehicles and became self-insured for these risks. Actual losses of $45,000 during 2007 were charged to delivery expense. The 2006 premium for the discontinued coverage amounted to $100,000, and the controller wants to set up a reserve for self-insurance by a debit to delivery expense of $55,000 and a credit to the reserve for self-insurance of $55,000.

3. A suit for breach of contract seeking damages of $1,000,000 was filed by an author against Greenlaw on July 3, 2007. The company’s legal counsel believes that an unfavorable outcome is probable. A reasonable estimate of the court’s award to the plaintiff is in the range between $100,000 and $500,000. No amount within this range is a better estimate of potential damages than any other amount.

4. During December 2007 a competitor company filed suit against Greenlaw for industrial espionage claiming $2,000,000 in damages. In the opinion of management and company counsel, it is reasonably possible that damages will be awarded to the plaintiff. However, the amount of potential damages awarded to the plaintiff cannot be reasonably estimated.

Required
For each of the preceding situations, prepare the journal entry that should be recorded as of December 31, 2007, or explain why an entry should not be recorded. Show supporting computations in good form.

Palmer Company issued short-term commercial paper totaling $7 million. On December 31, 2007, the company’s year-end, Palmer intends to refinance the commercial paper by issuing long-term debt. However, because of the temporary existence of excess cash, $3 million of the liability is liquidated in February 2008, as the commercial paper matures. On March 1, 2008 Palmer issues $9 million of long-term bonds, with $3 million of the proceeds going to replenish the working capital used to liquidate the $3 million of commercial paper, $4 million to pay the remaining balance of the commercial paper due after April, and the remaining $2 million to finance an equipment modernization program at Palmer’s plant. Palmer’s December 31, 2007 year-end financial statements are issued on March 13, 2008.

Required
1. How will the $3 million of commercial paper liquidated prior to the refinancing be classified on Palmer’s December 31, 2007 balance sheet? Explain your reasoning.


Atwood Table Company has $8 million of short-term notes payable owed to City National Bank. On February 1, 2008 Atwood negotiates a revolving credit agreement providing for unrestricted borrowings up to $6 million. Borrowings will bear interest at 1% over the prevailing prime rate, will have stated maturities of 120 days, and will be continuously renewable for 120-day periods for four years. Atwood plans to refinance as much as possible of the notes outstanding with the proceeds available from this agreement. Assume that Atwood’s December 31, 2007 year-end financial statements are issued on March 30, 2008.

Required
Prepare a partial December 31, 2007 balance sheet for Atwood Table Company showing how the $8 million short-term debt should be reported.

Northern Manufacturing Company bought a piece of equipment by signing a non-interest-bearing $80,000, one-year note. The face value of the note includes the price of the equipment and the interest. The effective interest rate is an annual rate of 16%, and the note is to be paid in four $20,000 quarterly installments. The price of the equipment is the present value of the four payments discounted at the effective interest rate.

Required
1. Prepare all journal entries to record the preceding information. Present value techniques should be used.

2. If Northern’s financial statements were issued on June 30, 2007, what amount would the company report as notes payable?
P13-17 Comprehensive  Selected transactions of the Lizard Lick Corporation during 2007 are as follows:

Jan.  5  Purchased merchandise from Boston Company for $30,000; terms, 2/10, n/30. Purchases and accounts payable are recorded by Lizard Lick using the net price method.

Jan. 26  Paid the January 5 invoice.

Mar. 31  Purchased a van for $19,950 from the Hill Sales Company, paying $9,950 in cash and issuing a 12%, one-year note for the balance of the purchase price.

May  1  Borrowed money from the Mebane National Bank by discounting its own one-year, non-interest-bearing note made out for the maturity value of $50,000 at an interest rate of 12%.

Nov.  2  Received $500 from the Carr Mill Playhouse as a deposit to be refunded after certain rental furniture to be used in a play is returned on January 7, 2008.

Nov.  5  Made sales on credit to Jones Company for $15,000. Sales taxes of 6\%\% were added to the $15,000 price. (Ignore cost of goods sold.)

Nov.  6  Purchased another van at a cost of $18,000 from a company located in a state that does not levy a sales tax. The entire purchase price was paid in cash. Lizard Lick is located in a state that assesses a use tax of 6\%\% on non-salable equipment bought outside its sales tax authority. The van and the liability for the use tax are to be recorded.

Dec.  1  Estimated property taxes for the year December 1, 2007 to November 30, 2008 are $36,000 (ignore previous property taxes). The corporation follows the practice of recording its property tax by a monthly accrual starting one month following the lien date. The tax becomes a lien on December 1 and is payable in two installments on May 1 and October 1.

Dec. 31  Estimated quarterly income taxes for the last quarter of the year are $150,000.

Required
Prepare journal entries to record the preceding transactions for 2007. Include year-end interest accruals.

P13-18 Comprehensive  Selected transactions of the Shadrach Computer Corporation during November and December of 2007 are as follows:

Nov.  1  Borrowed money from the bank by issuing a non-interest-bearing, $40,000, 90-day note. The note is discounted on a 12% basis.

9  Sold 100 computers with a one-year warranty for $5,000 each on credit (ignore cost of goods sold). Past experience indicates that warranty costs average $125 per computer. The corporation uses the expense warranty accrual method for record keeping.

12  Sold 100 software packages at $300 each on credit (ignore cost of goods sold). With each software package the corporation offered a premium in the form of a package of disks for the return of one proof of purchase. The offer expires June 30, 2008. The cost of each package of disks is $5, and the company estimates that 80% of the premiums will be redeemed; therefore, 80 packages of disks were purchased on credit.

20  Paid $2,900 in fulfillment of the warranty agreement on several of the computers sold on November 9.

30  Accrued monthly vacation pay. Shadrach Computer Corporation has 90 employees, who are each paid an average of $160 per day. The corporation has a policy of allowing each employee 12 days' paid vacation per year; the related liability is recorded on a monthly basis. Employees are paid monthly; two-thirds of the employees work in the sales force and one-third work in the office.

30  Paid monthly payroll. Gross salaries for the sales force were $288,000 and for the office staff were $144,000. No vacations were taken during November. Income tax withholdings of 20% are applicable to the salaries of all employees. An 8% F.I.C.A. tax for both employees and employers is also applicable. These rates apply to all salaries because no employee’s salary has exceeded the maximum wage limit. The state allows the corporation a 1% unemployment compensation merit-rating reduction from the normal rate of 5.4%. The federal unemployment rate is 0.8%. Prior to October, each individual employee had accumulated a gross salary in excess of $7,000 for 2007.

Dec. 14 Twenty proofs of purchase were returned from the November 12 sale.

29  An individual filed suit against Shadrach Computer Corporation for damages caused in a November 5 accident that resulted when a member of the sales force hit the individual’s car while on personal business. The amount of the suit filed was $1,500. Because the employee was on personal business, the company’s insurance company will not pay the claim. In the opinion of the company’s attorney, the amount of the suit is reasonable; furthermore, the company believes it is likely to lose the suit.

31  Accrued monthly vacation pay.

31  Paid monthly payroll. Gross salaries for the sales force were $290,000 and for the office staff were $145,000. The salaries included $6,800 of vacation pay in the sales force and $3,200 of vacation pay in the office staff. The F.I.C.A. tax rate still applies to all wages, because no employee’s salary exceeded the maximum wage limit.
31 Recorded president’s bonus. The president receives a 10% bonus computed on income after deducting income taxes but before deducting the bonus. The corporation’s effective income tax rate is 30%, and income before income taxes and bonus for 2007 was $560,000. The bonus will be paid in January 2008.

Required
Prepare journal entries to record the preceding transactions of the Shadrach Computer Corporation for 2007. Include year-end accruals. Round all calculations to the nearest dollar.

COMMUNICATION

C13-1 Short-Term Debt Expected to Be Refinanced
The following is the current liability section of Hollo Hardware Company on December 31, 2007:

<table>
<thead>
<tr>
<th>Liability</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable, trade</td>
<td>$50,000</td>
</tr>
<tr>
<td>Notes payable, 12%, due February 19, 2008</td>
<td>$70,000</td>
</tr>
<tr>
<td>Unearned interest and revenue</td>
<td>$12,000</td>
</tr>
<tr>
<td><strong>Total current liabilities</strong></td>
<td><strong>$132,000</strong></td>
</tr>
</tbody>
</table>

On January 15, 2008 Hollo enters into an agreement with the local bank to receive a line of credit for $60,000, available for the next two years with payment due 2 years after the date of the loan. Interest at 1% above the prime rate will be charged quarterly. On February 15, 2008 Hollo borrows the money to refinance the short-term note due in three days.

Required
2. Would the result be the same if Hollo borrowed the money on February 26, 2008?

C13-2 Short-Term Debt Expected to Be Refinanced
While auditing the 2007 financial statements of Warder Corporation, you found evidence that the following were not included in its current liabilities on the December 31, 2007 balance sheet:

1. Convertible bonds maturing in 60 days that were never converted.
2. Note payable due two months after the balance sheet date, with refinancing agreement entered into four weeks after the balance sheet date.
3. Notes payable of Warder’s completely owned subsidiary due its stockholders and payable upon demand.
4. Deposits from customers on equipment ordered by them from Warder.

Required
Discuss the assumptions needed for Warder to correctly exclude the previously mentioned items from the December 31, 2007 current liabilities. The balance sheet was issued on March 3, 2008.

C13-3 Loss Contingencies
AICPA Adapted Part a. The two basic requirements for the accrual of a loss contingency are supported by several basic concepts of accounting. Three of these concepts are: periodicity (time periods), measurement, and objectivity.

Required
Discuss how the two basic requirements for the accrual of a loss contingency relate to the three concepts listed previously.

Part b. The following three independent sets of facts relate to (1) the possible accrual or (2) the possible disclosure by other means of a loss contingency.

Situation I
A company offers a one-year warranty for the product that it manufactures. A history of warranty claims has been compiled and the probable amount of claims related to sales for a given period can be determined.

Situation II
Subsequent to the date of a set of financial statements, but prior to the issuance of the financial statements, a company enters into a contract that will probably result in a significant loss to the company. The amount of the loss can be reasonably estimated.

Situation III
A company has adopted a policy of recording self-insurance for any possible losses resulting from injury to others by the company’s vehicles. The premium for an insurance policy for the same risk from an independent insurance company would have an annual cost of $2,000. During the period covered by the financial statements, there were no accidents involving the company’s vehicles that resulted in injury to others.
Required
Explain the accrual and/or type of disclosure necessary (if any) and the reason(s) why such disclosure is appropriate for each of the three independent sets of facts in the situations described here. Complete your response to each situation before proceeding to the next situation.

C13-4 Contingency Conditions and Disclosure
Loss contingencies may exist for companies. Write a short memo that answers the following questions.

C13-5 Contingency and Commitment
Supey Chemical Co. encountered the following two situations in 2007:

1. Supey must pay an indeterminate amount for toxic waste cleanup on its land. An adjoining land owner, Gap Toothpaste, sold its property because of possible toxic contamination by Supey of the water supply and resulting potential adverse public reaction towards its product. Gap sued Supey for damages. There is a reasonable possibility that Gap will prevail in the suit.
2. At December 31, 2007, Supey had a noncancellable purchase contract for 10,000 pounds of Chemical XZ, for delivery in June 2008. Supey does not hedge its contracts. Supey uses this chemical to make Product 2-Y. In December 2007, the U.S. Food and Drug Administration banned the sale of Product 2-Y in concentrated form. Supey will be allowed to sell Product 2-Y in a diluted form; however, it will take at least five years to use the 10,000 pounds of Chemical XZ. Supey believes the sales price of the diluted product will not be sufficient to recover the contract price of Chemical XZ.

Required
1. (a) In its 2007 financial statements, how should Supey report the toxic waste cleanup? Why is this reporting appropriate?
   (b) In its 2007 financial statements, how should Supey report Gap’s claim against it? Why is this reporting appropriate?
2. In its 2007 financial statements, how should Supey report the effects of the contract to purchase Chemical XZ? Why is this reporting appropriate?

C13-6 Various Liability Issues
Angela Company is a manufacturer of toys. During the year, the following situations arose:

1. A safety hazard related to one of its toy products was discovered. It is considered probable that liabilities have been incurred. Based on past experience, a reasonable estimate of the amount of loss can be made.
2. One of its small warehouses is located on the bank of a river and could no longer be insured against flood losses. No flood losses have occurred after the date that the insurance became unavailable.
3. This year, Angela began promoting a new toy by including a coupon, redeemable for a movie ticket, in each toy’s carton. The movie ticket, which costs Angela $2, is purchased in advance and then mailed to the customer when the coupon is received by Angela. Angela estimated, based on past experience, that 60% of the coupons would be redeemed. Forty percent of the coupons were actually redeemed this year, and the remaining 20% of the coupons are expected to be redeemed next year.

Required
1. How should Angela account for the toy promotion campaign in this year?

C13-7 Pending Damage Suit Disclosure
On January 15, 2008 a truck driver for Cork Transfer Company negligently rounded a curve that was also a bridge covering several local merchant shops. The truck jumped the guardrail and fell 30 feet onto one of the shops, causing highly flammable chemicals in the truck to explode. Although by February 22, 2008 (the date on which Cork’s financial statements for 2007 are issued), no claims had been filed against Cork, it fully expected that some will be filed in the future.

Required
Explain the accounting treatment, if any, Cork should give the contingent loss occurring from the wreck in the December 31, 2007 financial statements.

C13-8 Estimate Liability Arising from Loss Contingency
Worldwide Motors has produced “Stallions” for 10 years as of December 31, 2007. In a civil judgment against it on July 20, 2007, it was found that for the period of January 1, 2004 until the present, Worldwide was negligent in the design of the cars because the gasoline tank was positioned in the rear in such a way that it would explode upon impact.
with another car. On December 31, 2007 Worldwide estimated that its ultimate liability on the Stallions would total $9 million.

**Required**

Explain fully the accounting treatment World-wide should give to the contingency on its financial statements as of December 31, 2007.

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**C13-9 Various Contingency Issues**

Skinner Company has the following contingencies:

1. Potential costs due to the discovery of a possible defect related to one of its products. These costs are probable and can be reasonably estimated.
2. A potential claim for damages to be received from a lawsuit filed this year against another company. It is probable that proceeds from the claim will be received by Skinner next year.
3. Potential costs due to a promotion campaign whereby a cash refund is sent to customers when coupons are redeemed. Skinner estimated, based on past experience, that 70 percent of the coupons would be redeemed. Forty percent of the coupons were actually redeemed and the cash refunds sent this year. The remaining 30 percent of the coupons are expected to be redeemed next year.

**Required**

1. How should Skinner report the potential costs due to the discovery of a possible product defect? Explain why.
2. How should Skinner report this year the potential claim for damages that may be received next year? Explain why.
3. This year, how should Skinner account for the potential costs and obligations due to the promotion campaign?

---

**C13-10 Various Contingency Issues**

At December 31, 2007, Niki Company reviewed the following situations to consider their impact on its 2007 financial statements:

1. In December 2007, Niki became aware of a safety hazard related to one of its products. Estimates of the probable costs resulting from the hazard include highest, most likely, and lowest amounts.
2. During 2007, Niki received a note for goods sold to a customer. The note was sold, with recourse, to a bank. The customer filed for bankruptcy in December 2007, before the note’s 2008 due date.
3. In 2003, Niki moved and assigned the remaining 10 years of its old lease to Pro Company, an unrelated third party. Pro agreed to make all payments due on the assigned lease, but Niki has prime responsibility for the lease to the lessor. At December 31, 2007, it is reasonably possible that Pro will be unable to make all payments due on the assigned lease.

**Required**

For each of the preceding situations, state how Niki should report the impact, if any, on its 2007 financial statements, and explain why the reporting is appropriate.

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**C13-11 Product and Lawsuit Contingencies**

Reese Company sells two types of merchandise, Type A and Type B. Each carries a one-year warranty.

- **Type A merchandise**: Product warranty costs, based on past experience, will normally be 1% of sales.
- **Type B merchandise**: Product warranty costs cannot be reasonably estimated because this is a new product line. However, the chief engineer believes that product warranty costs are likely to be incurred.

Reese Company is also being sued for $2,000,000 for an injury caused to a child as a result of alleged negligence while the child was visiting the Reese Company plant in March 2007. The suit was filed in July 2007. Reese’s lawyer states that it is probable that Reese will lose the suit and be found liable for a judgment costing anywhere from $200,000 to $900,000. However, the lawyer states that the most probable judgment is $400,000.

**Required**

1. How should Reese report the estimated product warranty costs for each of the two types of merchandise mentioned earlier? Explain the rationale for your answer. Do not discuss deferred income tax implications, or disclosures that should be made in Reese’s 2007 financial statements or notes.
2. How should Reese report the suit in its 2007 financial statements? Explain the rationale for your answer. Include in your answer disclosures, if any, that should be made in Reese’s financial statements or notes.

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**C13-12 Analyzing Coca-Cola’s Current Liabilities and Contingencies Disclosures**

Refer to the financial statements and related notes of the Coca-Cola Company in Appendix A of this book.

**Required**

1. What were the total current liabilities at the end of 2004? What was the largest current liability?
2. What did accounts payable and accrued expenses consist of at the end of 2004?
3. What was the total loans and notes payable and what did they consist of at the end of 2004? What was the total of the lines of credit (and other short-term credit facilities) that were available to the company at the end of 2004? How much is outstanding? Why do you think the company disclosed the lines-of-credit information?
4. How much was the company contingently liable for in regard to the guarantees of indebtedness owed by third parties at the end of 2004? What does this mean? How likely is it that the company will have to satisfy these guarantees?
**C13-13 Ethics and Environmental Damage**

Hart Corporation is a chemical company that produces cleaning fluids of different types; it is the main employer in a small town. Stan Hart has been the company president for 15 years and is paid a salary plus a 10% bonus based on pretax income; he is also the major stockholder. After treatment to remove pollutants, Hart Company has been draining the waste water from its production process into a nearby river for many years. Over the past year (2007) there have been several “fish kills” in the river and at the end of 2007 the Environmental Protection Agency (EPA) filed a $1 million lawsuit against Hart for violation of pollution control laws.

You are an accountant for the firm that is auditing Hart’s 2007 financial statements. Preliminary calculations show that Hart earned a pretax income of $600,000 for 2007, before considering the effects of the lawsuit. In a discussion with Stan Hart and Bob Brandt, the company’s attorney, you raise the issue of whether or not to report the lawsuit in the company’s 2007 financial statements. Stan says, “I’ve been president of this company for long enough to know that we didn’t cause the fish kills; it must be something else. Furthermore, I don’t want anything included in the income statement that would jeopardize the company’s well being; the town depends on us. If we shut down, the town will die.” Bob replies “I generally agree with you. But you need to be realistic. I don’t expect the outcome of the lawsuit to be determined for a couple of years. However, there is a pretty good chance the company will lose. If that happens, then there is a 60 percent chance the loss will be $400,000 and a 40 percent chance the loss will be $1 million.” Stan replies “Okay, then lets put it in a note to the financial statements.”

**Required**

From a financial reporting and ethical standpoint, prepare a written report that recommends how to account for the lawsuit.

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**R13-1 Researching GAAP**

**Situation**

Bogan Company is in need of cash to finance its operations. The company creates a new company, Hall Company, which is wholly owned by Bogan. On November 1, 2007 Bogan sells inventory on credit to Hall Company for $50,000, which in turn immediately uses the inventory for a $40,000, 12% loan (guaranteed by Bogan) from 8th National Bank. Hall then uses the proceeds from the loan to repay $40,000 of the $50,000 owed to Bogan. Bogan agrees to continue to extend credit for nine months to Hall for the remaining $10,000. The inventory is Hall’s only asset and is stored in a public warehouse. Bogan agrees to pay Hall the $200 monthly storage fee and $400 per month for a financing fee at the end of each month. Bogan also agrees to repurchase the inventory from Hall for $50,000 at the end of July 2008. Bogan uses a perpetual inventory system; the cost of the inventory sold to Hall is $42,000. The president of Bogan has asked you how to account for this series of transactions in 2007.

**Directions**

Research the related generally accepted accounting principles and prepare a short memo to the president that explains how Bogan Company should record the sale of the inventory on November 1, 2007 and the payment of the fees at the end of November and December. Also explain how Bogan should report the recorded items in its 2007 financial statements. Cite your reference and applicable paragraph numbers.

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**R13-2 Researching GAAP**

**Situation**

Gilmatt Company developed a new product that it planned to sell directly to customers and to promote heavily because of “stiff” competition in the market place. Its marketing department did extensive market surveys and developed a marketing plan for this product. The plan called for a series of television commercials and magazine advertisements. The television commercials aired for two months (September and October) in 2007 to (a) advertise the product and (b) indicate to viewers that “$5 off” coupons would be appearing in forthcoming magazine advertisements. The magazine advertisements appeared evenly over a three-month period from November 2007 through January 2008 and further promoted the product, as well as included the coded $5-off coupons (which expired at the end of February 2008.) Gilmatt expected 20,000 coupons to be redeemed. During November and December 2007, Gilmatt sold 2,000 units of the new product at the $50 regular price and 8,000 units at the $45 coded-coupon price. In January 2008, the company sold another 3,000 units at $50 each and 7,000 units at $45 each. It expects customers to redeem another 5,000 coupons before the coupons expire. It is now late January 2008 and the company is preparing its 2007 annual report.

The marketing department has prepared the following schedule of its 2007 costs related to the advertising and
promotion of the new product: supervisor’s salary, $10,000; payroll of employees working on magazine advertising copy, $40,000; depreciation, $7,500; cost of television commercials (independently produced), $180,000; cost of magazine space for advertisements, $100,000; cost of television airtime, $300,000.

**Direction**

Research the related generally accepted accounting principles and indicate how Gilmatt Company should report the costs of marketing the new product and the related sales revenues on its 2007 financial statements. Cite your reference and applicable paragraph numbers.