

CURRENT LIABILITIES, PROVISIONS, AND CONTINGENCIES

CURRENT LIABILITIES

“What is a Liability?”

Liability is defined as present obligation of the company arising from past events, the settlement of which is expected to result in an outflow from the company of resources, embodying economic benefits.

Three essential characteristics:

1. Present obligation.
2. Arises from past events.
3. Results in an outflow of resources (cash, goods, services).



Underlying Concepts

To determine the appropriate classification of specific financial instruments, companies need proper definitions of assets, liabilities, and equities. They often use the Conceptual Framework definitions as the basis for resolving controversial classification issues.

CURRENT LIABILITIES

Recall: **Current assets** are cash or other assets that companies reasonably expect to convert into cash, sell, or consume in operations within a single **operating cycle** or within a year.

Current liabilities are “obligations whose liquidation is reasonably expected to require use of existing resources properly classified as current assets, or the creation of other current liabilities.”

A **current liability** is reported if one of **two conditions** exists:

1. Liability is expected to be settled within its normal operating cycle; or
2. Liability is expected to be settled within 12 months after the reporting date.

The **operating cycle** is the period of time elapsing between the acquisition of goods and services and the final cash realization resulting from sales and subsequent collections.

CURRENT LIABILITIES

Typical Current Liabilities:

1. Accounts payable.
2. Notes payable.
3. Current maturities of long-term debt.
4. Short-term obligations expected to be refinanced.
5. Dividends payable.
6. Customer advances and deposits.
7. Unearned revenues.
8. Sales and value-added taxes payable.
9. Income taxes payable.
10. Employee-related liabilities.

CURRENT LIABILITIES

Accounts Payable (trade accounts payable)

Balances owed to others for goods, supplies, or services purchased on open account.

- ◆ Arises because of time lag between the receipt of services or acquisition of title to assets and the payment for them.
- ◆ Terms of the sale (e.g., 2/10, n/30 or 1/10, E.O.M.) usually state period of extended credit, commonly 30 to 60 days.
- ◆ These liabilities typically are noninterest-bearing and are reported at their face amounts.

CURRENT LIABILITIES

Notes Payable

Written promises to pay a certain sum of money on a specified future date.

- ◆ Arise from purchases, financing, or other transactions.
- ◆ Notes classified as short-term or long-term.
- ◆ Notes may be interest-bearing or zero-interest-bearing.

CURRENT LIABILITIES

Interest-Bearing Note Issued

Illustration: Castle National Bank agrees to lend €100,000 on March 1, 2015, to Landscape Co. if Landscape signs a €100,000, 6 percent, four-month note. Landscape records the cash received on March 1 as follows:

Cash	100,000
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Notes Payable	100,000
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Interest-Bearing Note Issued

If Landscape prepares financial statements semiannually, it makes the following adjusting entry to recognize interest expense and interest payable at June 30, 2015:

Interest calculation = $(€100,000 \times 6\% \times 4/12) =$
€2,000

Interest Expense	2,000
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Interest Payable	2,000
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Interest-Bearing Note Issued

At maturity (July 1, 2016), Landscape records payment of the note and accrued interest as follows.

Notes Payable	100,000
Interest Payable	2,000
Cash	102,000

CURRENT LIABILITIES

Zero-Interest-Bearing Note Issued

This note does not explicitly state an interest rate on the face of a note. Interest is still charged, however. At maturity, the borrower must pay back an amount greater than the cash received at issuance date.

Illustration: On March 1, Landscape issues a €102,000, four-month, zero-interest-bearing note to Castle National Bank. The present value of the note is €100,000. Landscape records this transaction as follows.

Cash	100,000	
Notes Payable		100,000

Zero-Interest-Bearing Note Issued

If Landscape prepares financial statements semiannually, it makes the following adjusting entry to recognize interest expense and the increase in the note payable of €2,000 at June 30.

Interest Expense	2,000
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Notes Payable/Discount on N/P	2,000
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At maturity (July 1), Landscape must pay the note, as follows.

Notes Payable	102,000
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Cash	102,000
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CURRENT LIABILITIES

E13-2: (Accounts and Notes Payable) The following are selected 2015 transactions of Darby Corporation.

Sept. 1 - Purchased inventory from Orion Company on account for \$50,000. Darby records purchases gross and uses a periodic inventory system.

Oct. 1 - Issued a \$50,000, 12-month, 8% note to Orion in payment of account.

Oct. 1 - Borrowed \$75,000 from the Shore Bank by signing a 12-month, zero-interest-bearing \$81,000 note.

Prepare journal entries for the selected transactions.

CURRENT LIABILITIES

Sept. 1 - Purchased inventory from Orion Company on account for \$50,000. Darby records purchases gross and uses a periodic inventory system.

Sept. 1	Purchases	50,000	
	Accounts Payable		50,000

CURRENT LIABILITIES

Oct. 1 - Issued a \$50,000, 12-month, 8% note to Orion in payment of account.

Oct. 1	Accounts Payable	50,000	
	Notes Payable		50,000

Interest calculation = $(\$50,000 \times 8\% \times 3/12) =$
\$1,000

Dec. 31	Interest Expense	1,000	
	Interest Payable		1,000

CURRENT LIABILITIES

Oct. 1 - Borrowed \$75,000 from the Shore Bank by signing a 12-month, zero-interest-bearing \$81,000 note.

Oct. 1	Cash	75,000	
	Notes Payable		75,000

Interest calculation = $(\$6,000 \times 3/12) = \mathbf{\$1,500}$

Dec. 31	Interest Expense	1,500	
	Notes Payable		1,500

CURRENT LIABILITIES

Current Maturities of Long-Term Debt

Portion of bonds, mortgage notes, and other long-term indebtedness that matures within the next fiscal year. It categorizes this amount as **current maturities of long-term debt**

Exclude long-term debts maturing currently if they are to be:

1. Retired by assets accumulated that have not been shown as current assets,

2. Refinanced, or retired from the proceeds of a new debt issue, or

- 13-163. Converted into ordinary shares.

CURRENT LIABILITIES

Short-Term Obligations Expected to Be Refinanced

Refinancing a short term obligation on a long term basis means either replacing it with a long term obligation or equity securities or renewing, extending or replacing it with short term obligations for an uninterrupted period extending beyond one year (or the normal operating cycle) from the date of the company's statement of financial position.

Exclude from current liabilities if **both** of the following conditions are met:

1. Must intend to refinance the obligation on a long-term basis.
- 13-14 2. Must have an unconditional right to defer settlement of the liability for at least 12 months after the reporting date.

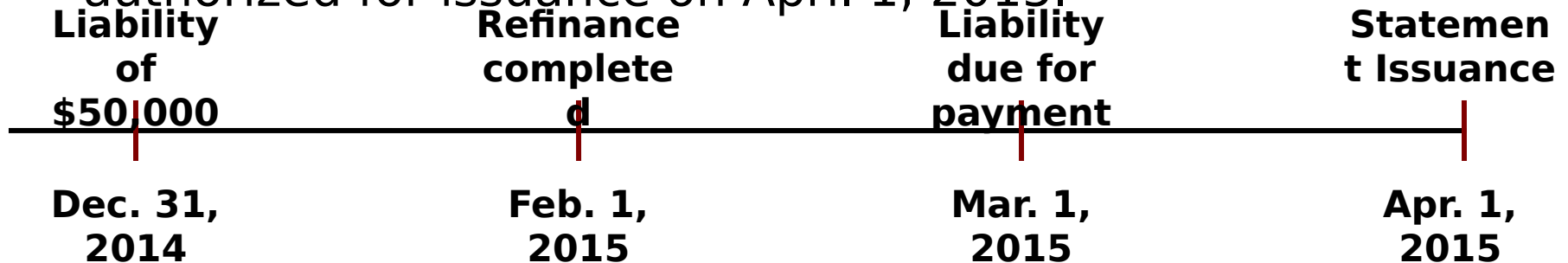
CURRENT LIABILITIES

E13-4 (Refinancing of Short-Term Debt): The CFO for Yong Corporation is discussing with the company's chief executive officer issues related to the company's short-term obligations. Presently, both the current ratio and the acid-test ratio for the company are quite low, and the chief executive officer is wondering if any of these short-term obligations could be reclassified as long-term. The financial reporting date is December 31, 2014. Two short-term obligations were discussed, and the following action was taken by the CFO.

Instructions: Indicate how these transactions should be reported at Dec. 31, 2014, on Yongs' statement of financial position.

CURRENT LIABILITIES

Short-Term Obligation A: Yong has a \$50,000 short-term obligation due on March 1, 2015. The CFO discussed with its lender whether the payment could be extended to March 1, 2017, provided Yong agrees to provide additional collateral. An agreement is reached on February 1, 2015, to change the loan terms to extend the obligation's maturity to March 1, 2017. The financial statements are authorized for issuance on April 1, 2015.



CURRENT LIABILITIES

Short-Term Obligation A: Yong has a \$50,000 short-term obligation due on March 1, 2015. The CFO discussed with its lender whether the payment could be extended to March 1, 2017, provided Yong agrees to provide additional collateral. An agreement is reached on February 1, 2015, to change the loan terms to extend the obligation's maturity to March 1, 2017. The financial statements are authorized for issuance on April 1, 2015.

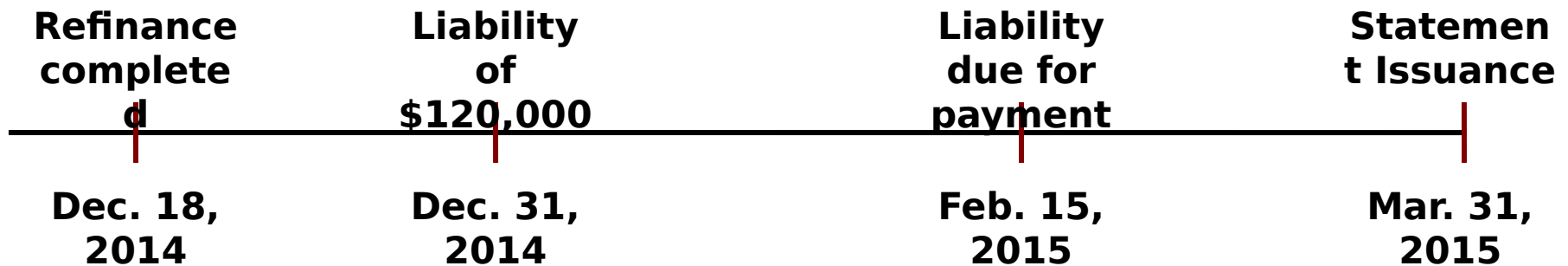
**Current
Liability of
\$50,000**

**Dec. 31,
2015**

Since the agreement was not in place as of the reporting date (December 31, 2015), the obligation should be reported as a **current liability**.

CURRENT LIABILITIES

Short-Term Obligation B: Yong also has another short-term obligation of \$120,000 due on February 15, 2015. In its discussion with the lender, the lender agrees to extend the maturity date to February 1, 2016. The agreement is signed on December 18, 2014. The financial statements are authorized for issuance on March 31, 2015.



CURRENT LIABILITIES

Short-Term Obligation B: Yong also has another short-term obligation of \$120,000 due on February 15, 2015. In its discussion with the lender, the lender agrees to extend the maturity date to February 1, 2016. The agreement is signed on December 18, 2014. The financial statements are authorized for issuance on March 31, 2015.



Current Liabilities

Illustration: On December 31, 2014, Alexander Company had \$1,200,000 of short-term debt in the form of notes payable due February 2, 2015. On January 21, 2015, the company issued 25,000 shares of its common stock for \$36 per share, receiving \$900,000 proceeds after brokerage fees and other costs of issuance. On February 2, 2015, the proceeds from the stock sale, supplemented by an additional \$300,000 cash, are used to liquidate the \$1,200,000 debt. The December 31, 2014, balance sheet is issued on February 23, 2015.

Instructions:

Show how the \$1,200,000 of short-term debt should be presented on the December 31, 2014, balance sheet,

13-23 including note disclosure

CURRENT LIABILITIES: *Dividends*

~~Payable~~

Amount owed by a corporation to its stockholders as a result of board of directors' authorization.

- ◆ Because companies always pay cash dividends within one year of declaration (generally within three months), they classify them as current liabilities.
- ◆ Undeclared dividends on cumulative preference shares not recognized as a liability. Why? Because **preferred dividends in arrears** are not an obligation until the board of directors authorizes the payment.
- ◆ Dividends payable in the form of additional shares are not recognized as a liability because such **stock dividends** do not require future outlays of assets or services.

▶ Reported in equity because they represent

CURRENT LIABILITIES

Customer Advances and Deposits

Returnable cash deposits received from customers and employees.

- ◆ To guarantee performance of a contract or service or
- ◆ As guarantees to cover payment of expected future obligations.

Note: *May be classified as **current** or **non-current** liabilities. The classification of these items as current or noncurrent liabilities depends on the time between the date of the deposit and the termination of the relationship that required the deposit*

CURRENT LIABILITIES: *Unearned Revenues*

Payment received before providing goods or performing services.

How do these companies account for **unearned revenues** ?

1. When a company receives an advance payment, it debits Cash, and credits a current liability account identifying the source of the unearned revenue.

2. When a company recognizes revenue, it debits the

Type of Business	Account Title	
	Unearned Revenue	Revenue
Airline	Unearned Passenger Ticket Revenue	Passenger Revenue
Magazine publisher	Unearned Subscription Revenue	Subscription Revenue
Hotel	Unearned Rental Revenue	Rental Revenue
Auto dealer	Unearned Warranty Revenue	Warranty Revenue
Retailers	Unearned Gift Card Revenue	Sales Revenue

CURRENT LIABILITIES

BE13-6: Sports Pro Magazine sold 12,000 annual subscriptions on August 1, 2015, for €18 each. Prepare Sports Pro's August 1, 2015, journal entry and the December 31, 2015, annual adjusting entry.

Aug. 1	Cash	216,000	
	Unearned Revenue		216,000
	(12,000 x €18)		

Dec. 31	Unearned Revenue	90,000	
	Subscription Revenue		90,000
	(€216,000 x 5/12 = €90,000)		

CURRENT LIABILITIES

Sales and Value-Added Taxes Payable

Consumption taxes are generally either

- ◆ a sales tax or
- ◆ a value-added tax (VAT).

Purpose is to generate revenue for the government.

The two systems use different methods to accomplish this objective.

Sales Taxes Payable

Illustration: Halo Supermarket sells loaves of bread to consumers on a given day for €2,400. Assuming a sales tax rate of 10 percent, Halo Supermarket makes the following entry to record the sale.

Cash	2,640	
Sales Revenue		2,400
Sales Taxes Payable		240

Value-Added Taxes Payable

Illustration: The VAT is collected every time a business purchases products from another business in the product's supply chain. To illustrate,

1. Hill Farms Wheat Company grows wheat and sells it to Sunshine Baking for €1,000. Hill Farms Wheat makes the following entry to record the sale, assuming the VAT is 10 percent.

Cash	1,100		
Sales Revenue		1,000	
Value-Added Taxes Payable			100

Value-Added Taxes Payable

2. Sunshine Baking makes loaves of bread from this wheat and sells it to Halo Supermarket for €2,000. Sunshine Baking makes the following entry to record the sale, assuming the VAT is 10 percent.

Cash	2,200		
	Sales Revenue	2,000	
	Value-Added Taxes Payable		200

Sunshine Baking then remits €100 to the government, not €200. The reason: Sunshine Baking has already paid €100 to Hill Farms Wheat.

Value-Added Taxes Payable

3. Halo Supermarket sells the loaves of bread to consumers for €2,400. Halo Supermarket makes the following entry to record the sale, assuming the VAT is 10 percent.

Cash	2,640		
	Sales Revenue	2,400	
	Value-Added Taxes Payable		240

Halo Supermarket then sends only €40 to the tax authority as it deducts the €200 VAT already paid to Sunshine Baking.

CURRENT LIABILITIES

Income Tax Payable

Businesses must prepare an income tax return and compute the income tax payable.

- ◆ Taxes payable are a current liability.
- ◆ Corporations must make periodic tax payments.
- ◆ Differences between taxable income and accounting income sometimes occur. Because of these differences, the amount of income taxes payable to the government in any given year may differ substantially from income tax expense as reported on the financial statements.

CURRENT LIABILITIES

Employee-Related Liabilities

Amounts owed to employees for salaries or wages are reported as a current liability.

Current liabilities may include:

- ◆ Payroll deductions.
- ◆ Compensated absences.
- ◆ Bonuses.

Employee-Related Liabilities

Payroll Deductions

To the extent that a company has not remitted the amounts deducted to the proper authority at the end of the accounting period, it should recognize them as current liabilities.

Taxes:

- ▶ Social Security Taxes
- ▶ Income Tax Withholding

Item	Who Pays	
Income tax withholding		}
Social Security taxes—employee share	Employee	
Union dues		
Social Security taxes—employer share	Employer	

Employer reports these amounts as liabilities until remitted.

Employee-Related Liabilities

Illustration: Assume a weekly payroll of \$10,000 entirely subject to Social Security taxes (8%), with income tax withholding of \$1,320 and union dues of \$88 deducted. The company records the wages and salaries paid and the **employee payroll deductions** as follows.

Wages and Salaries Expense	10,000	
Withholding Taxes Payable		1,320
Social Security Taxes Payable		800
Union Dues Payable		88
Cash		7,792

Employee-Related Liabilities

Illustration: Assume a weekly payroll of \$10,000 entirely subject to Social Security taxes (8%), with income tax withholding of \$1,320 and union dues of \$88 deducted. The company records the **employer payroll taxes** as follows.

Payroll Tax Expense	800
Social Security Taxes Payable	800

The employer must remit to the government its share of Social Security tax along with the amount of Social Security tax deducted from each employee's gross compensation.

Employee-Related Liabilities

Compensated Absences

Paid absences for vacation, illness and maternity, paternity, and jury leaves.

Companies should accrue a liability for the cost of compensation for future absences if **all of the following conditions** exist.

(a) The employer's obligation relating to employees' rights to receive compensation for future absences is attributable to employees' services **already rendered**.

(b) The obligation relates to the rights that **vest or accumulate**.

(c) Payment of the compensation is **probable**.

(d) The amount can be **reasonably estimated**.

Employee-Related Liabilities

Compensated Absences

The following considerations are relevant to the accounting for compensated absences.

Vested rights - employer has an obligation to make payment to an employee even after terminating his or her employment. Thus, vested rights are not contingent on an employee's future service.

Accumulated rights - employees can carry forward to future periods if not used in the period in which earned.

Non-accumulating rights - do not carry forward; they lapse if not used.

Companies should recognize the expense and related liability for compensated absences in the year earned by employees.

Employee-Related Liabilities

Illustration: Amutron Inc. began operations on January 1, 2015. The company employs 10 individuals and pays each €480 per week. Employees earned 20 unused vacation weeks in 2015. In 2016, the employees used the vacation weeks, but now they each earn €540 per week. Amutron accrues the accumulated vacation pay on **December 31, 2015**, as follows.

Salaries and Wages Expense	9,600	
Salaries and Wages Payable		9,600

In 2016, it records the payment of vacation pay as follows.

Salaries and Wages Payable	9,600	
Salaries and Wages Expense	1,200	
Cash		10,800

Employee-Related Liabilities

Profit-Sharing and Bonus Plans

Payments to certain or all employees in addition to their regular salaries or wages.

Frequently the bonus amount depends on the company's yearly profit.

A company may consider **bonus payments to employees** as additional wages and should include them as a deduction in determining the net income for the year.

- ◆ Bonuses paid are an operating expense.
- ◆ Unpaid bonuses should be reported as a current liability.

PROVISIONS

Provision is a liability of uncertain timing or amount.

Reported either as **current or non-current** liability.

Common types are

- ▶ Obligations related to litigation (lawsuits)
- ▶ Warranties or product guarantees
- ▶ Business restructurings.
- ▶ Environmental damage.

Uncertainty about the timing or amount of the future expenditure required to settle the obligation.

Recognition of a Provision

Companies accrue an expense and related liability for a provision only if the following three conditions are met:

1. Company has a present obligation (legal or constructive) as a result of a past event;
2. Probable that an outflow of resources will be required to settle the obligation; and
3. A reliable estimate can be made.

Recognition of a Provision

Recognition Examples

A reliable estimate of the amount of the obligation can be determined.

WARRANTY

Facts: Santos Company gives warranties to its customers related to the sale of its electrical products. The warranties are for three years from the date of sale. Based on past experience, it is probable (more likely than not) that there will be some claims under the warranties.

Question: Should Santos recognize at the statement of financial position date a provision for the warranty costs yet to be settled?

Solution: (1) The warranty is a present obligation as a result of a past obligating event—the past obligating event is the sale of the product with a warranty, which gives rise to a legal obligation. (2) The warranty results in the outflow of resources embodying benefits in settlement—it is probable that there will be some claims related to these warranties. Santos Company should recognize the provision based on past experience.

ILLUSTRATION 13-5

Recognition of a Provision—Warranty

Recognition Examples

Constructive obligation is an obligation that derives from a company's actions where:

1. By an established pattern of past practice, published policies, or a sufficiently specific current statement, the company has indicated to other parties that it will accept certain responsibilities; and
2. As a result, the company has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

Recognition Examples

A reliable estimate of the amount of the obligation can be determined.

REFUNDS

Facts: **Christian Dior** (FRA) has a policy of refunding purchases to dissatisfied customers even though it is under no legal obligation to do so. Its policy of making refunds is generally known.

Question: Should Christian Dior record a provision for these refunds?

Solution: (1) The refunds are a present obligation as a result of a past obligating event—the sale of the product. This sale gives rise to a constructive obligation because the conduct of the company has created a valid expectation on the part of its customers that it will refund purchases. (2) The refunds result in the outflow of resources in settlement—it is probable that a proportion of goods are returned for refund. A provision is recognized for the best estimate of the costs of refunds.

ILLUSTRATION 13-6

Recognition of a Provision—Refunds

Recognition Examples

A reliable estimate of the amount of the obligation can be determined.

Facts: Assume that an employee filed a £1,000,000 lawsuit on November 30, 2015, against **Wm Morrison Supermarkets** for damages suffered when the employee slipped and suffered a serious injury at one of the company's facilities. Morrison's lawyers believe that Morrison will not lose the lawsuit, putting the probability at less than 50 percent.

Question: Should Morrison recognize a provision for legal claims at December 31, 2015?

Solution: Although a past obligating event has occurred (the injury leading to the filing of the lawsuit), **it is not probable (more likely than not)** that Morrison will have to pay any damages. Morrison therefore does not need to record a provision. If, on the other hand, Morrison's lawyer determined that it is probable that the company will lose the lawsuit, then Morrison should recognize a provision at December 31, 2015.

ILLUSTRATION 13-7

13-47 Recognition of a Provision—Lawsuit

Measurement of Provisions

How does a company determine the amount to report for a provision?

IFRS:

Amount recognized should be the **best estimate of the expenditure required to settle the present obligation.**

Best estimate represents the amount that a company would pay to settle the obligation at the statement of financial position date.

Measurement of Provisions

Measurement Examples

Management must use judgment, based on past or similar transactions, discussions with experts, and any other pertinent information.



Toyota warranties. Toyota might determine that 8 percent of its cars will not have any warranty cost, 12 percent will have substantial costs, and 8 percent will have a much smaller cost. In this case, by weighting all the possible outcomes by their associated probabilities, Toyota **arrives at an expected value** for its warranty liability.

Measurement of Provisions

Measurement Examples

Management must use judgment, based on past or similar transactions, discussions with experts, and any other pertinent information.



Carrefour refunds. Carrefour sells many items at varying selling prices. Refunds to customers for products sold may be viewed as a continuous range of refunds, with each point in the range having the same probability of occurrence. In this case, the **midpoint in the range** can be used as the basis for measuring the amount of the refunds.

Measurement of Provisions

Measurement Examples



Novartis lawsuit. Large companies like Novartis are involved in numerous litigation issues related to their products. Where a single obligation such as a lawsuit is being measured, **the most likely outcome** of the lawsuit may be the best estimate of the liability.

Measurement of the liability should consider the time value of money, if material. Future events that may have an impact on the measurement of the costs should be considered.

Common Types of Provisions

Common Types:

- | | |
|--------------------------|----------------------|
| 1. Lawsuits | 4. Environmental |
| 2. Warranties | 5. Onerous contracts |
| 3. Consideration payable | 6. Restructuring |

IFRS requires extensive disclosure related to **provisions** in the notes to the financial statements. Companies **do not record** or report in the notes **general risk contingencies** inherent in business operations (e.g., the possibility of war, strike, uninsurable catastrophes, or a business recession).

Common Types of Provisions

Litigation Provisions

Companies must consider the following in determining whether to record a liability with respect to **pending or threatened litigation** and actual or possible **claims** and **assessments**.

1. The **time period** in which the underlying cause of action occurred.
2. The **probability** of an unfavorable outcome.
3. Ability to make a **reasonable estimate** of the amount of loss.

Litigation Provisions

With respect to **unfiled suits** and **unasserted claims and assessments**, a company must determine

1. the degree of **probability** that a suit may be filed or a claim or assessment may be asserted, and
2. the **probability** of an unfavorable outcome.

If both are probable, if the loss is reasonably estimable, and if the cause for action is dated on or before the date of the financial statements,

Litigation Provisions

BE13-12: Scorse Inc. is involved in a lawsuit at December 31, 2015. (a) Prepare the December 31 entry assuming it is probable that Scorse will be liable for 900,000 as a result of this suit. (b) Prepare the December 31 entry, if any, assuming it is *not* probable that Scorse will be liable for any payment as a result of this suit.

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

(b) No entry is necessary. The loss is not accrued because it is not probable that a liability has been incurred at 12/31/15.

Common Types of Provisions

Warranty Provisions

Promise made by a seller to a buyer to make good on a deficiency of quantity, quality, or performance in a product.

If it is probable that customers will make warranty claims and a company can reasonably estimate the costs involved, the company must record an expense.

Warranty Provisions

Companies often provide one of two types of warranties to customers:

Assurance-Type Warranty

A quality guarantee that the good or service is free from defects at the point of sale.

- ◆ Obligations should be expensed in the period the goods are provided or services performed (in other words, at the point of sale).
- ◆ Company should record a warranty liability.

Assurance-Type Warranty

Facts: Denson Machinery Company begins production of a new machine in July 2015 and sells 100 of these machines for \$5,000 cash by year-end. Each machine is under warranty for one year. Denson estimates, based on past experience with similar machines, that the warranty cost will average \$200 per unit. Further, as a result of parts replacements and services performed in compliance with machinery warranties, it incurs \$4,000 in warranty costs in 2015 and \$16,000 in 2016.

Question: What are the journal entries for the sale and the related warranty costs for 2015 and 2016?

Assurance-Type Warranty

Solution: For the sale of the machines and related warranty costs in 2015 the entry is as follows.

1. To recognize sales of machines and accrual of warranty liability:

July-December 2015

Cash	500,000	
Warranty Expense	20,000	
Warranty Liability		20,000
Sales Revenue		500,000

Assurance-Type Warranty

Solution: For the sale of the machines and related warranty costs in 2015 the entry is as follows.

2. To record payment for warranties incurred:

July–December 2015

Warranty Liability	4,000
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Cash, Inventory, Accrued Payroll	
4,000	

The December 31, 2015, statement of financial position reports Warranty Liability as a current liability of \$16,000. The income statement for 2015 reports Warranty Expense of \$20,000.

Assurance-Type Warranty

Solution: For the sale of the machines and related warranty costs in 2015 the entry is as follows.

3. To record payment for warranty costs incurred in 2016 related to 2015 machinery sales:

January 1-December 31, 2016

Warranty Liability 16,000

Cash, Inventory, Accrued Payroll

16,000

At the end of 2016, no warranty liability is reported for the machinery sold in 2015.

Warranty Provisions

Companies often provide one of two types of warranties to customers:

Service-Type Warranty

An extended warranty on the product at an additional cost.

- ◆ Usually recorded in an Unearned Warranty Revenue account.
- ◆ Recognize revenue on a straight-line basis over the period the service-type warranty is in effect.

Service-Type Warranty

Facts: You purchase an automobile from Hamlin Auto for €30,000 on January 2, 2014. Hamlin estimates the assurance-type warranty costs on the automobile to be €700 (Hamlin will pay for repairs for the first 36,000 miles or three years, whichever comes first). You also purchase for €900 a service-type warranty for an additional three years or 36,000 miles. Hamlin incurs warranty costs related to the assurance-type warranty of €500 in 2014 and €200 in 2015. Hamlin records revenue on the service-type warranty on a straight-line basis.

Question: What entries should Hamlin make in 2014 and 2017?

Service-Type Warranty

Solution:

1. To record the sale of the automobile and related warranties:

January 2, 2014

Cash (€30,000 + €900)	30,900	
Warranty Expense	700	
Warranty Liability	700	
Unearned Warranty Revenue		900
Sales Revenue	30,000	

Service-Type Warranty

Solution:

2. To record warranty costs incurred in 2014:

January 2-December 31, 2014

Warranty Liability 500

Cash, Inventory, Accrued Payroll
500

Service-Type Warranty

Solution:

3. To record revenue recognized in 2017 on the service-type warranty:

January 1-December 31, 2017

Unearned Warranty Revenue ($\text{€}900 \div 3$)	300
Warranty Revenue	300

Common Types of Provisions

Consideration Payable

Companies often make payments (provide consideration) to their customers as part of a revenue arrangement.

Companies offer premiums, coupon offers, and rebates to stimulate sales.

- ◆ Companies should charge **the costs of premiums and coupons to expense in the period of the sale** that benefits from the plan.

Consideration Payable

Facts: Fluffy Cake Mix Company sells boxes of cake mix for £3 per box. In addition, Fluffy Cake Mix offers its customers a large durable mixing bowl in exchange for £1 and 10 box tops. The mixing bowl costs Fluffy Cake Mix £2, and the company estimates that customers will redeem 60 percent of the box tops. The premium offer began in June 2015. During 2015, Fluffy Cake Mix purchased 20,000 mixing bowls at £2, sold 300,000 boxes of cake mix for £3 per box, and redeemed 60,000 box tops.

Question: What entries should Fluffy Cake Mix record in 2015?

Consideration Payable

Solution:

- 1. To record purchase of 20,000 mixing bowls at £2 per bowl:**

Premium Inventory (20,000 bowls x £2)	40,000
Cash	40,000

Consideration Payable

Solution:

2. Before Fluffy Cake Mix makes the entry to record the sale of the cake mix boxes, it determines its premium expense and related premium liability. This computation is as

Total box tops sold in 2015	300,000
Estimated redemptions (in percent)	<u>60%</u>
Total estimated redemptions	<u>180,000</u>
Cost of estimated redemptions	
$[(180,000 \text{ box tops} \div 10) \times (\text{£}2 - \text{£}1)]$	<u>£18,000</u>

Consideration Payable

Solution:

2. The entry to record the sale of the cake mix boxes and premium expense and premium liability is as follows.

Cash (300,000 boxes x £3)	900,000
Premium Expense	18,000
Sales Revenue	900,000
Premium Liability	18,000

Consideration Payable

Solution:

3. To record the actual redemption of 60,000 box tops, the receipt of £1 per 10 box tops, and the delivery of the mixing bowls:

Cash $[(60,000 \div 10) \times £1]$ 6,000

Premium Liability 6,000

Premium Inventory $[(60,000 \div 10) \times £2]$
12,000

Common Types of Provisions

Environmental Provisions

Estimates to clean up existing toxic wastes sites are substantial. In addition, cost estimates of cleaning up our air and preventing future deterioration of the environment run even higher.

A company must recognize an **environmental liability** when it has an existing legal obligation associated with the retirement of a long-lived asset and when it can reasonably estimate the amount of the liability.

Environmental Provisions

Obligating Events. Examples of existing legal obligations, which require recognition of a liability include, but are not limited to:

- ▶ Decommissioning nuclear facilities,
- ▶ Dismantling, restoring, and reclamation of oil and gas properties,
- ▶ Certain closure, reclamation, and removal costs of mining facilities,
- ▶ Closure and post-closure costs of landfills.

Environmental Provisions

Measurement. A company initially measures an environmental liability at the best estimate of its future costs.

Recognition and Allocation. To record an environmental liability a company includes

- ▶ the cost associated with the environmental liability in the carrying amount of the related long-lived asset, and
- ▶ records a liability for the same amount.

Environmental Provisions

Illustration: On January 1, 2015, Wildcat Oil Company erected an oil platform in the Gulf of Mexico. Wildcat is legally required to dismantle and remove the platform at the end of its useful life, estimated to be five years. Wildcat estimates that dismantling and removal will cost \$1,000,000. Based on a 10 percent discount rate, the fair value of the environmental liability is estimated to be \$620,920 ($\$1,000,000 \times .62092$). Wildcat records this liability on Jan. 1, 2015 as follows.

Drilling Platform 620,920

Environmental Liability

620,920

Environmental Provisions

Illustration: During the life of the asset, Wildcat allocates the asset retirement cost to expense. Using the straight-line method, Wildcat makes the following entries to record this expense.

December 31, 2015, 2016, 2017, 2018

Depreciation Expense ($\$620,920 \div 5$) 124,184

 Accumulated Depreciation—Plant Assets

 124,184

Environmental Provisions

Illustration: In addition, Wildcat must accrue interest expense each period. Wildcat records interest expense and the related increase in the environmental liability on December 31, 2015, as follows.

December 31, 2015

Interest Expense ($\$620,920 \times 10\%$)	62,092
Environmental Liability	62,092

Environmental Provisions

Illustration: On January 10, 2020, Wildcat contracts with Rig Reclaimers, Inc. to dismantle the platform at a contract price of \$995,000. Wildcat makes the following journal entry to

record settlement of the liability.

January 10, 2020

Environmental Liability 1,000,000

 Gain on Settlement of Environmental Liability

 5,000

Cash 995,000

Common Types of Provisions

Onerous Contract Provisions

“The unavoidable costs of meeting the obligations exceed the economic benefits expected to be received.”

An example of an onerous contract is a loss recognized on unfavorable non cancelable commitments relate to inventory items.

The expected costs should reflect the least net cost of exiting from the contract, which is the lower of

1. the cost of fulfilling the contract, or
2. the compensation or penalties arising from failure to fulfill the contract.

Onerous Contract Provisions

Illustration: Sumart Sports operates profitably in a factory that it has leased and on which it pays monthly rentals. Sumart decides to relocate its operations to another facility. However, the lease on the old facility continues for the next three years. Unfortunately, Sumart cannot cancel the lease nor will it be able to sublet the factory to another party. The expected costs to satisfy this onerous contract are €200,000. In this case, Sumart makes the following entry.

Loss on Lease Contract 200,000

Lease Contract Liability	200,000
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Onerous Contract Provisions

Assume the same facts as above for the Sumart example and the expected costs to fulfill the contract are €200,000. However, Sumart can cancel the lease by paying a penalty of €175,000. In this case, Sumart should record the liability as follows.

Loss on Lease Contract 175,000

Lease Contract Liability	175,000
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Common Types of Provisions

Self-Insurance

Self-insurance is not insurance, but risk assumption.

There is **little theoretical justification** for the establishment of a liability based on a hypothetical charge to insurance expense.

Conditions for accrual stated in **IFRS** are not satisfied prior to the occurrence of the event.

Disclosure Related to Provisions

A company must provide a reconciliation of its beginning to ending balance for each major class of provisions, identifying what caused the change during the period.

In addition,

- ▶ Provision must be described and the expected timing of any outflows disclosed.
- ▶ Disclosure about uncertainties related to expected outflows as well as expected reimbursements should be provided.

CONTINGENCIES

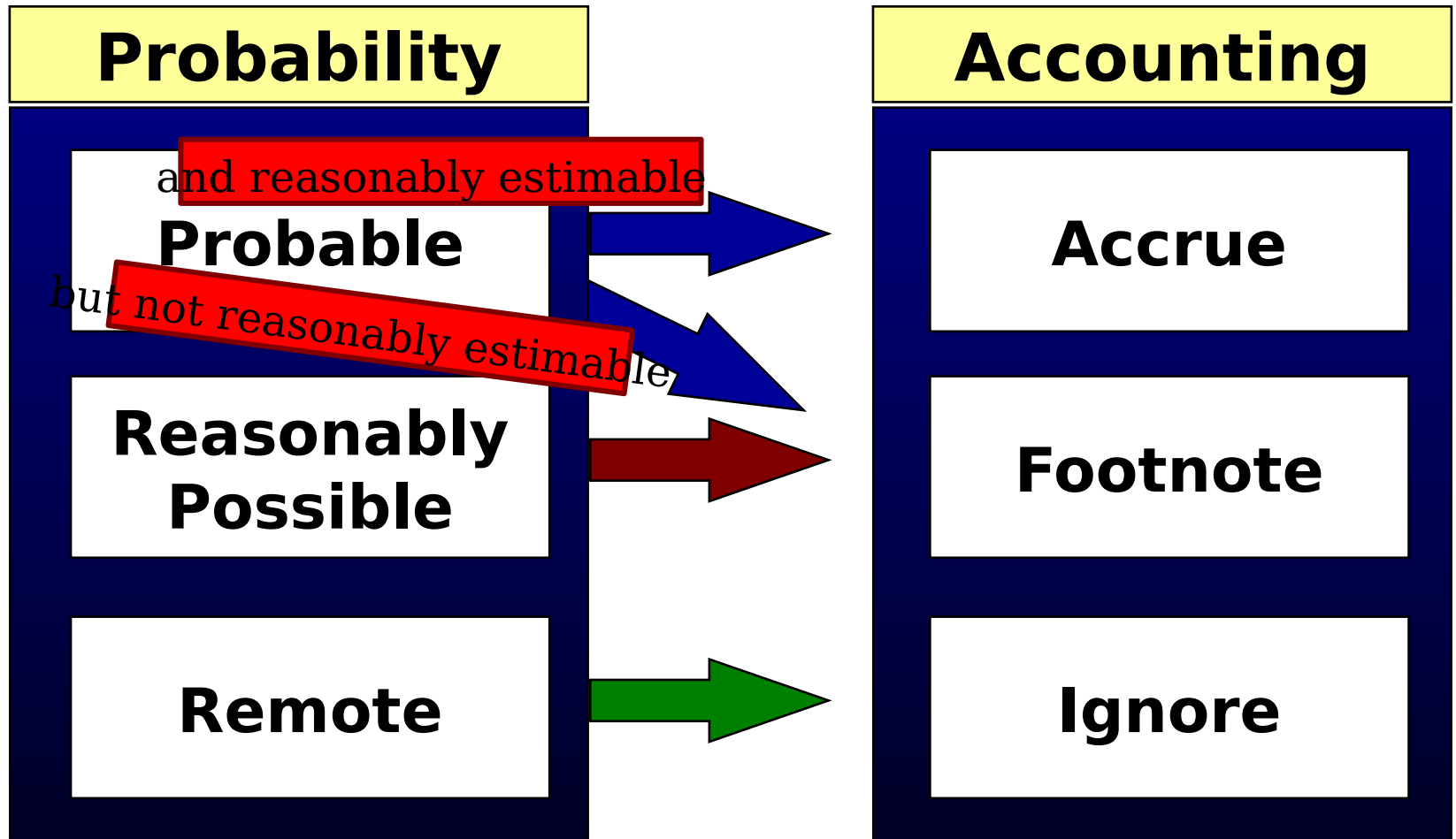
“An existing condition, situation, or set of circumstances involving uncertainty as to possible gain **(gain contingency)** or loss **(loss contingency)** to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur.”

Contingent Liabilities/Loss

Contingencies are not recognized in the financial statements because they are

1. A possible obligation (not yet confirmed),
2. A present obligation for which it is not probable that payment will be made, or
3. A present obligation for which a reliable estimate of the obligation cannot be made.

Loss Contingencies



Contingent Liabilities

Illustration 13-16 presents the general guidelines for the accounting and reporting of contingent liabilities.

Outcome	Probability*	Accounting Treatment
Virtually certain	At least 90%	Report as liability (provision).
Probable (more likely than not)	51–89% probable	Report as liability (provision).
Possible but not probable	5–50%	Disclosure required.
Remote	Less than 5%	No disclosure required.
*In practice, the percentages for virtually certain and remote may deviate from those presented here.		

ILLUSTRATION 13-16

Contingent Liability
Guidelines

CONTINGENCIES

Contingent Assets/Gain Contingencies

A **contingent asset** is a possible asset that arises from past events and whose existence will be confirmed by the occurrence or non-occurrence of uncertain future events not wholly within the control of the company. Typical contingent assets are:

1. Possible receipts of monies from gifts, donations, bonuses.
2. Possible refunds from the government in tax disputes.

Contingent assets are not recognized on the statement of financial position.

3. Pending court cases with a probable favorable outcome.

Contingent Assets

The general rules related to contingent assets are presented in Illustration 13-18.

Outcome	Probability*	Accounting Treatment
Virtually certain	At least 90% probable	Report as asset (no longer contingent).
Probable (more likely than not)	51–90% probable	Disclose.
Possible but not probable	5–50%	No disclosure required.
Remote	Less than 5%	No disclosure required.
*In practice, the percentages for virtually certain and remote may deviate from those presented here.		

ILLUSTRATION 13-18

Contingent Asset Guidelines

Contingent assets are disclosed when an inflow of economic benefits is considered more likely than not to occur (greater than 50 percent).

PRESENTATION AND ANALYSIS

Presentation of Current Liabilities

- ◆ Usually reported at their full maturity value.
- ◆ Difference between present value and the maturity value is considered immaterial.

GLOBAL ACCOUNTING INSIGHTS

LIABILITIES

U.S. GAAP and IFRS have similar definitions for liabilities. In addition, the accounting for current liabilities is essentially the same under both IFRS and U.S. GAAP.

GLOBAL ACCOUNTING INSIGHTS

Relevant Facts

Similarities

- U.S. GAAP and IFRS have similar liability definitions. Both also classify liabilities as current and non-current.
- Both U.S. GAAP and IFRS require the best estimate of a probable loss. In U.S. GAAP, the minimum amount in a range is used. Under IFRS, if a range of estimates is predicted and no amount in the range is more likely than any other amount in the range, the midpoint of the range is used to measure the liability.
- Both U.S. GAAP and IFRS prohibit the recognition of liabilities for future losses.

GLOBAL ACCOUNTING INSIGHTS

Relevant Facts

Differences

- Under U.S. GAAP, companies must classify a refinancing as current only if it is completed before the financial statements are issued. IFRS requires that the current portion of long-term debt be classified as current unless an agreement to refinance on a long-term basis is completed before the reporting date.
- U.S. GAAP uses the term contingency in a different way than IFRS. A contingency under U.S. GAAP may be reported as a liability under certain situations. IFRS does not permit a contingency to be recorded as a liability.
- U.S. GAAP uses the term estimated liabilities to discuss various liability items that have some uncertainty related to timing or amount. IFRS generally uses the term provisions.

GLOBAL ACCOUNTING INSIGHTS

Relevant Facts

Differences

- U.S. GAAP and IFRS are similar in the treatment of environmental liabilities. However, the recognition criteria for environmental liabilities are more stringent under U.S. GAAP: Environmental liabilities are not recognized unless there is a present legal obligation and the fair value of the obligation can be reasonably estimated.
- U.S. GAAP uses the term troubled debt restructurings and develops recognition rules related to this category. IFRS generally assumes that all