Chapter 11
Current Liabilities and Contingencies

M. Problems

P11-1. ***Suggested solution:***

Item	Liability	Financial or non-financial obligation?	Explanation
1.	Accounts payable	F	
2.	Warranties payable	N	Obligation is to deliver goods or services
3.	USD bank loan	F	
4.	Bank overdraft	F	
5.	Sales tax payable	N	Obligation is not contractual in nature
6.	Notes payable	F	
7.	Unearned revenue	N	Obligation is to deliver goods or services
8.	Finance lease obligation	F	
9.	HST payable	N	Obligation is not contractual in nature
10.	Bank loan	F	
11.	Bonds payable	F	
12.	Obligation under customer loyalty plan	N	Obligation is to deliver goods or services
13.	Income taxes payable	N	Obligation is not contractual in nature

P11-2. ***Suggested solution:***

To be classified as a liability, the item must: i) be a present obligation; ii) have arisen from a past event; and iii) be expected to result in an outflow of economic benefits. This is an "and" situation as all three criteria must be present before a liability is recorded. The precise amount of the obligation need not be known, provided that a reliable estimate can be made of the amount due. Provisions are liabilities in which there is some uncertainty as to the timing or amount of payment.

Trade accounts payable meet the criteria of a liability as set out below:

* Present obligation: The debtor is presently contractually obliged to pay for goods or services received.
* Past event: The trade payable arose from a good or service the debtor previously received or consumed.
* Outflow of economic benefits: Trade payables are typically settled in cash—an outflow of economic benefits.

P11-3. ***Suggested solution:***

a. Provisions are liabilities in which there is some uncertainty as to the timing or amount of payment.
b. Financial liabilities are contracts to deliver cash or other financial assets to another party. They differ from non-financial liabilities as the latter category is typically settled through the provision of goods or services.
c. A non-exhaustive list of financial liabilities includes accounts payable; bank loans; notes payable; bonds payable; and finance leases. A non-exhaustive list of non-financial obligations includes warranties payable; unearned revenue; and income taxes payable.

P11-4. ***Suggested solution:***

a. The three broad categories of liabilities are:
   1. Financial liabilities held for trading
   2. Other financial liabilities
   3. Non-financial liabilities
b.
   * Held-for-trading liabilities are initially recognized at fair value.
   * Other financial liabilities are initially reported at fair value minus the transaction costs directly resulting from incurring the obligation.
   * The initial measurement of non-financial liabilities depends on their nature. For instance, warranties are recorded at management's best estimate of the downstream cost of meeting the entity's contractual obligations, while prepaid magazine subscription revenue is valued at the consideration initially received.
c.
   * Held-for-trading liabilities are subsequently recognized at fair value.
   * Other financial liabilities are subsequently measured at amortized cost using the effective rate method.
   * Non-financial liabilities are subsequently measured at the initial obligation less the amount earned to date or satisfied to date through performance. For example, a publisher that received $750 in advance for a three-year subscription and has delivered the magazine for one year would report an obligation of $500 ($750 – $250).

P11-5. ***Suggested solution:***

Item	Liability	Current or non-current liability, or potentially both?	Explanation
1.	Accounts payable	C	
2.	Warranties payable	B	The obligation that is expected to be settled within one year of the balance sheet date is current, the balance non-current
3.	Deposits	B	The classification of the deposit as current or non-current depends upon the expected settlement date. If less than one year after the balance sheet date, the obligation is classified as current
4.	Bank overdraft	C	
5.	Sales tax payable	C	
6.	Bank loan maturing in five years was in default during the year; before year-end, the lender grants a grace period that extends 12 months after the balance sheet date	N	The obligation is reported as a non-current liability because the grace period was granted before the balance sheet date and extends twelve months after year-end
7.	Five-year term loan, amortized payments are payable annually	B	The principal portion of the payments due within one year of the balance sheet date are classified as current, the balance as non-current
8.	Unearned revenue	B	The classification of the obligation as current or non-current depends upon when revenue is the expected to be recognized. If less than one year after the balance sheet date, the obligation is classified as current
9.	Finance lease obligation	B	The principal portion of the payments due within one year of the balance sheet date are classified as current, the balance as non-current
10.	HST payable	C	
11.	90-day bank loan	C	
12.	Bond payable that matures in two years	N	The obligation is reported as non-current as the maturity date is two years after the balance sheet date

13.	Obligation under customer loyalty plan	C	Classified as current as the entity does not have the unconditional right to defer settlement for twelve months after the reporting period.
14.	Income taxes payable	C	
15.	Bank loan that matures in five years that is currently in default	C	
16.	Three-year bank loan that matures six months after the balance sheet date	C	

P11-6. ***Suggested solution:***

Summary journal entries			
1.	Dr. Inventory	10,000	
	Dr. HST recoverable ($10,000 × 14%)	1,400	
	Cr. Accounts payable ($10,000 + $1,400)		11,400
2.	Dr. Equipment ($20,000 + $500)	20,500	
	Dr. HST recoverable ($20,500 × 14%)	2,870	
	Cr. Accounts payable ($20,500 + $2,870)		23,370
3.	Dr. Cash [$15,000 × (1 + 14%)]	17,100	
	Cr. Sales		15,000
	Cr. HST payable ($15,000 × 14%)		2,100
	Dr. Cost of goods sold ($15,000 x 50%)	7,500	
	Cr. Inventory		7,500
4.	Dr. Accounts receivable [$20,000 × (1 + 14%)]	22,800	
	Cr. Sales		20,000
	Cr. HST payable ($20,000 × 14%)		2,800
	Dr. Cost of goods sold ($20,000 x 50%)	10,000	
	Cr. Inventory		10,000
5.	Dr. Accounts payable	23,370	
	Cr. Cash		23,370
6.	Dr. HST payable ($12,000 + $2,100 + $2,800)	16,900	
	Cr. HST recoverable ($8,000 + $1,400 + $2,870)		12,270
	Cr. Cash ($16,900 – $12,270)		4,630

P11-7. ***Suggested solution:***

Summary journal entries			
1.	Dr. Inventory	12,000	
	Dr. HST recoverable ($12,000 × 15%)	1,800	
	Cr. Accounts payable ($12,000 + $1,800)		13,800
2.	Dr. Equipment ($15,000 + $1,000)	16,000	
	Dr. HST recoverable ($16,000 × 15%)	2,400	
	Cr. Accounts payable ($16,000 + $2,400)		18,400
3.	Dr. Cash [$11,000 × (1 + 15%)]	12,650	
	Cr. Sales		11,000
	Cr. HST payable ($11,000 × 15%)		1,650
	Dr. Cost of goods sold ($11,000 x 80%)	8,800	
	Cr. Inventory		8,800
4.	Dr. Accounts receivable [$20,000 × (1 + 15%)]	23,000	
	Cr. Sales		20,000
	Cr. HST payable ($20,000 × 15%)		3,000
	Dr. Cost of goods sold ($20,000 x 80%)	16,000	
	Cr. Inventory		16,000
5.	Dr. Accounts payable	13,800	
	Cr. Cash		13,800
6.	Dr. HST payable ($22,000 + $1,650 + $3,000)	26,650	
	Cr. HST recoverable ($20,000 + $1,800 + $2,400)		24,200
	Cr. Cash ($26,650 – $24,200)		2,450

P11-8. ***Suggested solution:***

Summary journal entries			
1.	Dr. Inventory ($42,000 – $2,000)	40,000	
	Dr. GST recoverable ($40,000 × 5%)	2,000	
	Cr. Accounts payable [$40,000 × (1 + 5%)]		42,000
	The purchase of inventory for resale is PST exempt.		
2.	Dr. Cash [$30,000 × (1 + 5% + 7%)]	33,600	
	Cr. Sales		30,000
	Cr. GST payable ($30,000 × 5%)		1,500
	Cr. PST payable ($30,000 × 7%)		2,100
	Dr. Cost of goods sold ($30,000 × 2/3)	20,000	
	Cr. Inventory		20,000
3.	Dr. Accounts receivable [$60,000 × (1 + 5% + 7%)]	67,200	
	Cr. Sales		60,000
	Cr. GST payable ($60,000 × 5%)		3,000
	Cr. PST payable ($60,000 × 7%)		4,200
	Dr. Cost of goods sold ($60,000 × 2/3)	40,000	
	Cr. Inventory		40,000
4.	Dr. GST payable ($20,000 + $1,500 + $3,000)	24,500	
	Dr. PST payable ($22,000 + $2,100 + $4,200)	26,300	
	Cr. GST recoverable ($21,000 + $2,000)		23,000
	Cr. Cash ($24,500 + $26,300 – $23,000)		27,800

P11-9. ***Suggested solution:***

Summary journal entries			
1.	Dr. Inventory	30,000	
	Dr. GST recoverable ($30,000 × 5%)	1,500	
	Cr. Accounts payable [$30,000 × (1 + 5%)]		31,500
	The purchase of inventory for resale is PST exempt.		
2.	Dr. Cash [$20,000 × (1 + 5% + 5%)]	22,000	
	Cr. Sales		20,000
	Cr. GST payable ($20,000 × 5%)		1,000
	Cr. PST payable ($20,000 × 5%)		1,000
	Dr. Cost of goods sold ($20,000 × 75%)	15,000	
	Cr. Inventory		15,000
3.	Dr. Accounts receivable [$50,000 × (1 + 5% + 5%)]	55,000	
	Cr. Sales		50,000
	Cr. GST payable ($50,000 × 5%)		2,500
	Cr. PST payable ($50,000 × 5%)		2,500
	Dr. Cost of goods sold ($50,000 × 75%)	37,500	
	Cr. Inventory		37,500
4.	Dr. GST payable ($18,000 + $1,000 + $2,500)	21,500	
	Dr. PST payable ($14,000 + $1,000 + $2,500)	17,500	
	Cr. GST recoverable ($15,000 + $1,500)		16,500
	Cr. Cash ($21,500 + $17,500 – $16,500)		22,500

P11-10. *Suggested solution:*

Oct. 31, 2019	Dr. Retained earnings	30,000	
	Cr. Dividends payable on preferred shares (10,000 sh × \$1.00/sh × 2) + (5,000 sh × \$2.00/sh) The preferred shares B are non-cumulative in nature and as such are not entitled to dividends for 2014 as they were not declared.		30,000
Nov. 30, 2019	Dr. Retained earnings	50,000	
	Cr. Dividends payable on common shares (100,000 sh × \$0.50 sh)		50,000
Dec. 1, 2019	Dr. Dividends payable on preferred shares	30,000	
	Cr. Cash		30,000
Jan. 2, 2020	Dr. Dividends payable on common shares	50,000	
	Cr. Cash		50,000

P11-11. *Suggested solution:*

Oct. 31, 2016	Dr. Retained earnings	175,000	
	Cr. Dividends payable on preferred shares (50,000 sh × \$2.00/sh) + (25,000 sh × \$1.00/sh × 3) The preferred shares A are non-cumulative in nature and as such are not entitled to dividends for 2014 or 2015 as they were not declared.		175,000
Nov. 30, 2016	Dr. Retained earnings	300,000	
	Cr. Common stock dividends distributable (200,000 sh × 10%/sh × \$15.00)		300,000
Dec. 1, 2016	Dr. Dividends payable on preferred shares	175,000	
	Cr. Cash		175,000
Jan. 2, 2017	Dr. Common stock dividends distributable	300,000	
	Cr. Common shares		300,000

P11-12. ***Suggested solution:***

Jan. 31	Dr. Franchise fee expense	2,500	
	Cr. Royalty fee payable		2,500
	($50,000 × 5%)		
	Dr. Sales and marketing expense	1,250	
	Cr. Royalty fee payable		1,250
	($50,000 × 2.5%)		
Feb. 15	Dr. Royalty fee payable	3,750	
	Cr. Cash		3,750
	($2,500 + $1,250)		
Feb. 28	Dr. Franchise fee expense	2,000	
	Cr. Royalty fee payable		2,000
	($40,000 × 5%)		
	Dr. Sales and marketing expense	1,000	
	Cr. Royalty fee payable		1,000
	($40,000 × 2.5%)		
Mar. 15	Dr. Royalty fee payable	3,000	
	Cr. Cash		3,000
	($2,000 + $1,000)		
Mar. 31	Dr. Franchise fee expense	3,000	
	Cr. Royalty fee payable		3,000
	($60,000 × 5%)		
	Dr. Sales and marketing expense	1,500	
	Cr. Royalty fee payable		1,500
	($60,000 × 2.5%)		
Apr. 15	Dr. Royalty fee payable	4,500	
	Cr. Cash		4,500
	($3,000 + $1,500)		

P11-13. *Suggested solution:*

a.	Jan. 1, 2016	Dr. Franchise agreement	30,000	
		Cr. Cash		30,000
	Dec. 31, 2016	Dr. Amortization expense - franchise	3,000	
		Cr. Franchise agreement		3,000
		($30,000/10 years)		
	Dec. 31, 2016	Dr. Royalty fee expense	59,500	
		Cr. Royalty fee payable		59,500
		($850,000 × 7%)		
	Dec. 31, 2016	Dr. Sales and marketing expense	17,000	
		Cr. Royalty fee payable		17,000
		($850,000 × 2%)		
b.	Jan. 15, 2017	Dr. Royalty fee payable	76,500	
		Cr. Cash		76,500
		($59,500 + $17,000)		

P11-14. *Suggested solution:*

a. Summary journal entries

2018	Dr. Cash (6 × $2,000)	12,000	
	Cr. Deferred revenue		12,000
2018	Dr. Cash (2 × $3,000)	6,000	
	Dr. Deferred revenue (2 × $2,000)	4,000	
	Cr. Revenue (2 × $5,000)		10,000
	Dr. Cost of goods sold (2 × $2,300)	4,600	
	Cr. Cash		4,600
2019	Dr. Cash (4 × $3,000)	12,000	
	Dr. Deferred revenue (4 × $2,000)	8,000	
	Cr. Revenue (4 × $5,000)		20,000
	Dr. Cost of goods sold (4 × $2,300)	9,200	
	Cr. Cash		9,200

b. The balance in the deferred revenue account as at December 31, 2018 was $8,000 ($12,000 – $4,000 or $2,000 × 4)

P11-15. ***Suggested solution:***

1.

Dr. Warranty expense	30,000	
Cr. Provision for warranty obligations		30,000
2,500 × ($5 + $7) = $30,000		

2.

Dr. Provision for warranty obligations	6,000	
Cr. Wage expense		6,000

3. The total provision for warranty obligations that will be reported at year-end is $24,000 ($30,000 – $6,000). Of this amount, $6,500 will be reported as a current obligation [(2,500 × $5) – $6,000 = $6,500] and the $17,500 balance as a non-current liability (2,500 × $7 = $17,500) or ($24,000 – $6,500 = $17,500).

4. Companies offer warranties that their products will be free from defects for a specified period to facilitate the sale of their merchandise.

P11-16. ***Suggested solution:***

The obligation is initially valued at the spot exchange rate evident on the transaction date and revalued at period end using the period ending spot rate.

May 1, 2016	Dr. Cash (US$140,000 × C$1.02 / US$1.00)	142,800	
	Cr. Bank loan		142,800
Dec. 31, 2016	Dr. Foreign exchange loss (US$140,000 × (C$1.04 – C$1.02) / US$1.00)	2,800	
	Cr. Bank loan		2,800

P11-17. ***Suggested solution:***

The obligation is initially valued at the spot exchange rate evident on the transaction date and revalued at period end and payment date using the applicable spot rate.

Dec. 15, 2015	Dr. Supplies expense (US$5,000 × C$1.04 / US$1.00)	5,200	
	Cr. Trade account payable		5,200
Dec. 31, 2015	Dr. Trade account payable	150	
	Cr. Foreign exchange gain (US$5,000 × (C$1.04 – C$1.01) / US$1.00)		150
Jan. 3, 2016	Dr. Foreign exchange loss	100	
	Cr. Trade account payable (US$5,000 × (C$1.03 – C$1.01) / US$1.00)		100
	Dr. Trade account payable ($5,200 - $150 + $100)	5,150	
	Cr. Cash (US$5,000 × C$1.03 / US$1.00)		5,150

P11-18. ***Suggested solution:***

a. Revenue is recognized for the award portion of company-offered rewards when the customer claims their reward. Revenue is recognized for the award portion of third-party rewards at the time of sale.
b. The transaction price must be allocated to the sales and award performance obligations based on their relative stand-alone selling prices.

P11-19. ***Suggested solution:***

Summary journal entries		
To recognize the sales-related revenue in 2015		
a. Dr. Cash (20,000 × $600)	12,000,000	
Cr. Sales		11,700,000
Cr. Provision for manufacturer's rebates ((20,000 × $50 × 30%)		300,000
Dr. Cost of goods sold (20,000 × $350)	7,000,000	
Cr. Inventory		7,000,000
To recognize the issuance of the rebate cheques in 2016		
b. Dr. Provision for manufacturer's rebates	300,000	
Cr. Cash		300,000

P11-20. ***Suggested solution:***

a.	Dr. Computer system	19,231	
	Cr. Note payable ($20,000 / 1.04)		19,231
	Using a BAII PLUS financial calculator 1N, 4 I/Y, 20000 FV, CPT PV PV = –19,231		
b.	Dr. Interest expense	769	
	Cr. Note payable		769
	$19,231 × 4% = $769		
c.	Dr. Note payable	20,000	
	Cr. Cash		20,000
	No entry for interest is required as it had been accrued on December 31, 2014.		

P11-21. ***Suggested solution:***

a.	Dr. Automobile	40,000	
	Cr. Note payable		30,000
	Cr. Cash		10,000
b.	Dr. Interest expense	605	
	Cr. Accrued interest payable		605
	$30,000 × 4% × 184 / 365 = $605 (rounded)		
c.	Dr. Interest expense	296	
	Dr. Accrued interest payable	605	
	Dr. Note payable	30,000	
	Cr. Cash ($30,000 + $296 + $605)		30,901
	$30,000 × 4% × 90 / 365 = $296 (rounded)		

P11-22. ***Suggested solution:***

a.

Nov. 15, 2017	Dr. Supplies inventory	4,900	
	Cr. Trade payables		4,900
	[$5,000 × (100% – 2%)]		
Nov. 22, 2017	Dr. Equipment—washing machines	8,000	
	Cr. Notes payable		8,000
	Recorded at face value as it is a short-term note and the interest component is immaterial		
Nov. 28, 2017	Dr. Cash	20,000	
	Cr. Notes payable		20,000
Nov. 30, 2017	Dr. Interest expense (bank loan)	7	
	Cr. Cash ($20,000 × 4% × 3/365 = $7 (rounded))		7
Dec. 18, 2017	Dr. Supplies inventory	3,920	
	Cr. Trade payables ($4,000 × (100% – 2%))		3,920
Dec. 21, 2017	Dr. Equipment—dryers	9,615	
	Cr. Notes payable ($10,000 / 1.04)		9,615
	Using a BAII PLUS financial calculator 1 N, 4 I/Y, 10,000 FV, CPT PV PV = –9,615 (rounded) 4% is an appropriate discount rate to use as the question identifies this as the market rate of interest for NVL's short-term borrowings		
Dec. 22, 2017	Dr. Trade payables	4,900	
	Dr. Purchase discounts lost	100	
	Cr. Cash		5,000
Dec. 22, 2017	Dr. Trade payables	3,920	
	Cr. Cash		3,920
Dec. 31, 2017	Dr. Payroll expense	20,000	
	Cr. Cash		18,600
	Cr. Employee remittances payable		1,400
Dec. 31, 2017	Dr. Interest expense (bank loan)	68	
	Cr. Cash ($20,000 × 4% × 31/365 = $68 (rounded))		68
Dec. 31, 2017	Dr. Interest expense (note payable)	12	
	Cr. Note payable		12
	[$9,615 × 4% × 11/365 = $12 (rounded)]		

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

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

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

P11-23. ***Suggested solution:***

Aug. 15	Dr. Equipment—inventory monitoring system	6,000	
	Cr. Notes payable		6,000
	Recorded at face value as it is a short-term note and the interest component is immaterial		
Aug. 18	Dr. Cash	10,000	
	Cr. Notes payable		10,000
Aug. 21	Dr. Inventory	8,000	
	Cr. Trade payables		8,000
Aug. 30	Dr. Interest expense (bank loan)	15	
	Cr. Cash ($10,000 × 4% × 14/365 = $15 (rounded))		15
Sept. 20	Dr. Equipment—waste management system	7,619	
	Cr. Notes payable ($8,000 / 1.05)		7,619
	Using a BAII PLUS financial calculator 1 N, 5 I/Y, 8,000 FV, CPT PV PV = –7,619 (rounded) 5% is an appropriate discount rate to use as the question identifies this as the market rate of interest for MEI's unsecured short-term borrowings		
Sept. 23	Dr. Inventory	3,000	
	Cr. Trade payables		3,000
Sept. 24	Dr. Trade payables ($8,000 + $3,000)	11,000	
	Cr. Inventory ($3,000 x 3%)		90
	Cr. Cash		10,910
	The discount was lost on the $8,000 payable as the invoice was outstanding for more than 10 days.		

Sept. 30	Dr. Utilities expense	1,700	
	Cr. Accrued trade payables		1,700
Sept. 30	Dr. Interest expense (bank loan)	33	
	Cr. Cash ($10,000 × 4% × 30/365 = $33 (rounded))		33
Sept. 30	Dr. Interest expense (note payable)	11	
	Cr. Note payable [$7,619 × 5% × 11/365 = $11 (rounded)]		11

P11-24. ***Suggested solution:***

Maturing obligations are classified as either current or non-current liabilities depending on the circumstances.

* If a renewal agreement is entered into before year-end, the obligation is classified as a non-current liability.
* If the loan is renewed after year-end, but before the statements are approved for issue, the obligation is classified as a current liability. The renewal is disclosed in the notes to the financial statements.
* If the loan is not renewed or renewed after the statements are approved for issue, the obligation is classified as a current liability.

P11-25. ***Suggested solution:***

Loans in default are classified as either current or non-current liabilities depending on the circumstances.

* If, before year-end, the lender agrees to a grace period to cure the defaults that extends at least twelve months after the balance sheet date, the obligation is classified as a non-current liability.
* If the lender agrees to a grace period to cure the default after year-end but before the statements are approved for issue, the obligation is classified as a current liability. Providing the grace period is for one year or more, the waiver of default is disclosed in the notes to the financial statements.
* If the lender does not agree to a grace period or its approval is received after the statements are approved for issue, the obligation is classified as a current liability.

P11-26. ***Suggested solution:***

a.			
Jan. 1	Dr. Cash	1,800,000	
	Cr. Deferred revenue		1,800,000
	10,000 × $180 = $1,800,000		
Apr. 1	Dr. Cash	900,000	
	Cr. Deferred revenue		900,000
	5,000 × $180 = $900,000		
Nov. 1	Dr. Cash	2,160,000	
	Cr. Deferred revenue		2,160,000
	12,000 × $180 = $2,160,000		

b.			
Dec. 31	Dr. Deferred revenue	945,000	
	Cr. Revenue		945,000
Dec. 31	Dr. Magazine expense	378,000	
	Cr. Cash		378,000

$180/36 = $5 in revenue per magazine sold

Sales date	Number sold—A	Months delivered—B	Revenue—A × B × $5	Expense—A × B × $2
Jan. 1	10,000	12	$600,000	$240,000
Apr. 1	5,000	9	225,000	90,000
Nov. 1	12,000	2	120,000	48,000
Revenue and expense to be recognized			$945,000	$378,000

P11-27. ***Suggested solution:***

a.			
Jan. 1	Dr. Cash	576,000	
	Cr. Deferred revenue		576,000
	8,000 × $72 = $576,000		
Feb. 1	Dr. Cash	432,000	
	Cr. Deferred revenue		432,000
	6,000 × $72 = $432,000		
Aug. 1	Dr. Cash	648,000	
	Cr. Deferred revenue		648,000
	9,000 × $72 = $648,000		
Dec. 1	Dr. Cash	864,000	
	Cr. Deferred revenue		864,000
	12,000 × $72 = $864,000		

b.			
Dec. 31	Dr. Deferred revenue	1,314,000	
	Cr. Revenue		1,314,000
Dec. 31	Dr. Production and delivery expense	657,000	
	Cr. Cash		657,000

$72/12 = $6 in revenue per month per newspaper subscription sold

Sales date	Number sold—A	Months delivered—B	Revenue—A × B × $6	Expense—A × B × $3
Jan. 1	8,000	12	$ 576,000	$288,000
Feb. 1	6,000	11	396,000	198,000
Aug. 1	9,000	5	270,000	135,000
Dec. 1	12,000	1	72,000	36,000
Revenue and expense to be recognized			$1,314,000	$657,000

P11-28. ***Suggested solution:***

To recognize the provision in 2017		
a. Dr. Warranty expense	240,000	
Cr. Provision for warranty payable		240,000
[$4,800,000 × (1% + 2% + 2%)]		
To recognize partial satisfaction of the warranty obligation in 2017		
Dr. Provision for warranty payable	240,000	
Cr. Parts inventory		150,000
Cr. Wage expense		90,000
To recognize the provision in 2018		
Dr. Warranty expense	378,000	
Cr. Provision for warranty payable		378,000
($5,400,000 × 7%)		
To recognize partial satisfaction of the warranty obligation in 2018		
Dr. Provision for warranty payable	300,000	
Cr. Parts inventory		180,000
Cr. Wage expense		120,000

b. The balance in the warranty payable account as at December 31, 2018 was $338,000 as set out in the T-account that follows:

Provision for Warranty Payable			
		260,000	Balance Dec. 31, 2016
		240,000	Provision 2017
Claims 2017	240,000		
		378,000	Provision 2018
Claims 2018	300,000		
		338,000	Balance Dec. 31, 2018

P11-29. ***Suggested solution:***

The obligation is initially valued at the spot exchange rate evident on the transaction date and revalued at period end using the period ending spot rate. Interest is charged to expense at the average rate for the period, rather than the spot raid paid at time of payment. The difference is recognized as a gain or loss on the income statement.

Dec. 1, 2018	Dr. Cash (US$1,000,000 × C$1.08 / US$1.00)	1,080,000	
	Cr. Bank loan		1,080,000
Dec. 31, 2018	Dr. Interest expense (US$1,000,000 × 5.0% × 31/365× C$1.09 / US$1.00)	4,629	
	Dr. Foreign exchange loss	42	
	Cr. Cash (US$1,000,000 × 5.0% × 31/365× C$1.10 / US$1.00)		4,671
Dec. 31, 2018	Dr. Foreign exchange loss (US$1,000,000 × (C$1.10 – C$1.08) / US$1.00)	20,000	
	Cr. Bank loan		20,000

P11-30. ***Suggested solution:***

a. As per Canadian Tire Corporation, Limited's balance sheet as at December 28, 2013, the company reported current liabilities totaling $4,322.1 million categorized as follows:

Type of liability	**Amount owing on Dec. 28, 2013 – in $millions**
Bank indebtedness	$ 69.0
Deposits	1,178.4
Trade and other payables	1,817.4
Provisions	196.1
Short-term borrowings	120.3
Loans payable	611.2
Income taxes payable	57.5
Current portion of long-term debt	272.2
Total current liabilities	$4,322.1

b. As per Note 21, the categories of provisions reported by Canadian Tire follow:

Type of provision	**Amount owing on Dec. 28, 2013 – in $millions**		
	Total	**Long-term**	**Current**
Sales and warranty returns	$109.5	$ 4.1	**$105.4**
Site restoration and decommissioning	32.4	23.0	**9.4**
Onerous contracts	3.2	0.2	**3.0**
Customer loyalty	71.2	1.4	**69.8**
Other	18.0	9.5	**8.5**
Total	$234.3	$38.2	**$196.1**

c. As per Note 23, Canadian Tire reports its commercial paper at amortized cost.
d. Canadian Tire reported $7,977.8 million in current assets at December 28, 2013. Its current ratio was thus $7,977.8 / $4,322.1 = 1.85:1 and its working capital was $7,977.8 million - $4,322.1 million = $3,655.7 million.

P11-31. ***Suggested solution:***

Summary journal entries		
To recognize the flight-related revenue in 2015		
a. Dr. Cash	8,000,000	
Cr. Flight revenue		7,910,000
Cr. Unearned revenue (award points)		90,000
To recognize reward point revenue in 2016		
b. Dr. Unearned revenue (award points)	36,000	
Cr. Award revenue		36,000
To recognize reward point revenue in 2017		
b. Dr. Unearned revenue (award points)	45,000	
Cr. Award revenue		45,000
Supporting computations and notes		

- 6,000,000 miles are expected to be redeemed (8,000,000 × 75% = 6,000,000). This translates into 500 flights (6,000,000 / [(15,000 + 25,000) / 2] = 300).

- To obtain the amount of reward revenue to recognize, the denominator is the number of miles expected to be redeemed rather than the number awarded. ($90,000 / 300 flights = $300).

- 120 reward flights are redeemed in 2016. (120 / 300 × $90,000 = $36,000).

- 150 reward flights are redeemed in 2017. (150 / 300 × $90,000 = $45,000).

P11-32. ***Suggested solution:***

Summary journal entries		
To recognize the sales-related revenue in 2018		
a. Dr. Cash	15,000,000	
Cr. Sales (given)		14,895,000
Cr. Unearned revenue (award points - given)		105,000
Dr. Cost of goods sold [14,895,000 / (1 + 50%)]	9,930,000	
Cr. Inventory		9,930,000
To recognize premium revenue in 2019		
b. Dr. Unearned revenue (award points)	30,000	
Cr. Sales		30,000
Dr. Cost of goods sold [30,000 / (1 + 50%)]	20,000	
Cr. Inventory		20,000
To recognize premium revenue in 2020		
b. Dr. Unearned revenue (award points)	45,000	
Cr. Sales		45,000
Dr. Cost of goods sold [45,000 / (1 + 50%)]	30,000	
Cr. Inventory		30,000
Supporting computations and notes		
- 3,000,000 points are redeemed in 2020. (3,000,000 / 1,000 × $10 = $30,000).		
- 4,500,000 points are redeemed in 2021. (4,500,000 / 1,000 × $10 = $45,000).		

c. Companies offer incentive programs to increase sales.

P11-33. ***Suggested solution:***

Recall that the amount to be reported as a current liability is any accrued interest payable at balance sheet date plus the principal amount due within the twelve months immediately following the balance sheet date. If the loan becomes payable on demand due to a default by the borrower, the balance of the loan plus accrued interest is normally reported as a current liability. An exception to this requirement is made when the lender agrees **before** the statement date to waive the default for a period of **at least** one year after the balance sheet date.

The first step in answering this question it to create a loan amortization schedule matching the payment due date:

Loan amortization schedule – payments due December 31					
Date	**Interest expense**		**Payment**	**Loan reduction**	**Loan balance**
Jan. 1, 2016					$4,000,000
Dec. 31, 2016	$160,000	(a)	$898,508	$738,508	3,261,492
Dec. 31, 2017	130,460	(b)	898,508	768,048	2,493,444
(a) $4,000,000 × 4% = $160,000					
(b) $3,261,492 × 4% = $130,460 (rounded)					

Scenario 1 – the amount to be reported as a current liability is the $768,048 principal portion of the payment next due December 31, 2017. (Principal amount due within twelve months of the balance sheet date; no accrued interest payable).

Scenario 2 – the loan was in default as at year end and as such $4,160,000 should be reported as a current liability ($4,000,000 principal portion + $160,000 interest).

Loan amortization schedule – payments due January 1					
Date	**Interest expense**		**Payment**	**Loan reduction**	**Loan balance including accrued interest**
Jan. 1, 2016					$4,000,000
Dec. 31, 2016	$160,000	(a)			4,160,000
Jan. 1, 2017			$898,508	$898,508	3,261,492
Dec. 31, 2017	130,460	(b)			3,391,952
(a) $4,000,000 × 4% = $160,000					
(b) $3,261,492 × 4% = $130,460 (rounded)					

Scenario 3 – the amount to be reported as a current liability is the $898,508 payment due on January 1, 2017. This includes the $160,000 in accrued interest plus the $738,508 principal portion of the payment. (Principal amount due within twelve months of the balance sheet date plus accrued interest payable).

Scenario 4 – The grace period was not granted by the lender until after year-end so $4,160,000 should be reported as a current liability ($4,000,000 principal portion + $160,000 interest). As the covenant waiver was received before the financial statements were approved for acceptance, and as the grace period extended more than twelve months past the balance sheet date, this information may be disclosed in the notes to the financial statements as a non-adjusting event.

P11-34. *Suggested solution:*

a.

Dr. Cash	5,000,000	
Cr. Earned revenue		5,000,000
(1,000 × $5,000 = $5,000,000)		
Dr. Cost of goods sold	4,000,000	
Cr. Inventory		4,000,000
[$5,000,000 / (1 + 25%) = $4,000,000]		
Dr. Warranty expense	400,000	
Cr. Provision for warranty payable		400,000
(1,000 × $400 = $400,000)		
Dr. Provision for warranty payable	170,000	
Cr. Parts inventory		50,000
Cr. Wage expense		120,000

b.

Dr. Cash	5,000,000	
Cr. Earned revenue		5,000,000
(1,000 × $5,000 = $5,000,000)		
Dr. Cost of goods sold	4,000,000	
Cr. Inventory		4,000,000
[$5,000,000 / (1 + 25%) = $4,000,000]		
Dr. Warranty expense	170,000	
Cr. Parts inventory		50,000
Cr. Wage expense		120,000

c. The cash basis cannot normally be used to account for warranty expenses as it does not properly match expenses to revenues. In the example above, 2018's profitability is overstated $230,000 ($400,000 – $170,000) when the cash basis is used.

d. If management's provision subsequently proves to be incorrect, the change in estimate is adjusted for prospectively in the manner discussed in Chapter 3. Essentially Stanger will debit warranty expense for an additional $70,000 in 2019 when the new information (claims in excess of the provision) becomes known. Stanger is not required to restate 2018's results as this is a change in estimate, rather than an error.

P11-35. ***Suggested solution:***

a. Sales occurred evenly during the year, therefore in 2018 GHF earned, on average, six months of revenue on the maintenance contracts. As per the chart below, GHF earned revenues of $14,520.

a.	One year	Two year	Three year	Contract value	Revenue earned	Unearned revenue
Photocopiers	$240	$420	$600			
# of contracts sold	24	12	36			
$ value of contracts sold	$5,760	$5,040	$21,600	$32,400		
Revenue earned (%)*	50%	25%	16 ⅔%			
Revenue earned ($)	$2,880	$1,260	$3,600		$7,740	
Unearned revenue ($)	$2,880	$3,780	$18,000			$24,660
Fax machines	$180	$320	$450			
# of contracts sold	24	24	36			
$ value of contracts sold	$4,320	$7,680	$16,200	$28,200		
Revenue earned (%)	50%	25%	16⅔%			
Revenue earned ($)	$2,160	$1,920	$2,700		$6,780	
Unearned revenue ($)	$2,160	$5,760	$13,500			$21,420
				$60,600	$14,520	$46,080
* 6 months earned / 12 month contract = 50%; 6 month / 24 month contract = 25%; 6 month / 36 month contract = 16⅔%						

b. and c. Deferred revenue is $46,080 ($60,600 – $14,520 = $46,080). Of this, the remaining services to be provided under the one-year contract are current liabilities and the services to be provided in the next 12 months under the two- and three-year contracts are current liabilities. As per the chart below, $24,000 of GHF's deferred revenue should be reported as a current liability and $22,080 reported as a non-current liability.

b. and c.	**Total deferred**	**Current**	**Non-current**
Photocopiers			
One year	$2,880	$2,880	$0
Two year*	$3,780	$2,520	$1,260
Three year**	$18,000	$7,200	$10,800
Total	$24,660	$12,600	$12,060
Fax machines			
One year	$2,160	$2,160	$0
Two year***	$5,760	$3,840	$1,920
Three year****	$13,500	$5,400	$8,100
Total	$21,420	$11,400	$10,020
Total	$46,080	$24,000	$22,080

* The value of the two-year photocopier contracts sold was $5,040. One year of the two-year agreement is a current liability – $5,040 / 2 = $2,520

** The value of the three-year photocopier contracts sold was $21,600. One year of the three-year agreement is a current liability – $21,600 / 3 = $7,200

*** The value of the two-year fax machine contracts sold was $7,680. One year of the two-year agreement is a current liability – $7,680 / 2 = $3,840

**** The value of the three-year fax machine contracts sold was $16,200. One year of the three year agreement is a current liability – $16,200 / 3 = $5,400

P11-36. ***Suggested solution:***

a.

Dr. Unearned revenue	6,300	
Cr. Earned revenue		6,300
Passage of time—one-year memberships (180 × $420 / 12 = $6,300)		
Dr. Unearned revenue	3,600	
Cr. Earned revenue		3,600
Passage of time—two-year memberships (120 × $720 / 24 = $3,600)		
Dr. Cash	9,240	
Cr. Earned revenue		9,240
Pay as you go memberships (220 – 34 + 45 = 231; 231 × $40 = $9,240)		
Dr. Cash	8,400	
Cr. Unearned revenue		8,400
Sale of 20 new one-year memberships (20 × $420 = $8,400)		
Dr. Cash	7,200	
Cr. Unearned revenue		7,200
Sale of 10 new two-year memberships (10 × $720 = $7,200)		
Dr. Unearned revenue	8,400	
Cr. Earned revenue		8,400
Obligation fulfilled—112 personal trainer coupons redeemed (112 × $750 / 10 = $8,400)		
Dr. Cash	7,500	
Cr. Unearned revenue		7,500
Sale of 10 new personal trainer packages (10 × $750 = $7,500)		

b. The balance in the deferred revenue account as at January 31, 2017 was $117,150 as set out in the T-account that follows:

Unearned revenue			
		112,350	Balance Dec. 31, 2016
Passage of time—one year	6,300		
Passage of time—two years	3,600		
		8,400	Sale of one-year packages
		7,200	Sale of two-year packages
Redemption of PTP	8,400		
		7,500	Sale of PTP
		117,150	Balance Jan. 31, 2017

The two-year membership is the only product offered that gives rise to a non-current liability. In January, 10 new memberships were sold and five expired. Thus, the total obligation pertaining to the two-year memberships increased $3,600 [$720 × (10 – 5)]. Twelve months, or 50% of each membership, is a current obligation with the remainder being a non-current obligation. The non-current portion of the liability is $13,500 ($3,600 × 50% = $1,800; $11,700 + $1,800 = $13,500). The current portion of the liability is $103,650 ($117,150 – $13,500).

This is the shortcut way of doing this. You will obtain the same result if you construct a spreadsheet tracking the months remaining for all two-year memberships sold, segregating them as to currency.

$720 / 24 = $30 per month revenue						
Month sold	**# sold**	**Months left**	**Current**	**Non-current**	**$ current**	**$ non-current**
Feb. 2015	5	1	1	0	$ 150	$ -
Mar. 2015	5	2	2	0	$ 300	$ -
Apr. 2015	5	3	3	0	$ 450	$ -
May 2015	5	4	4	0	$ 600	$ -
Jun. 2015	5	5	5	0	$ 750	$ -
Jul. 2015	5	6	6	0	$ 900	$ -
Aug. 2015	5	7	7	0	$ 1,050	$ -
Sep. 2015	5	8	8	0	$ 1,200	$ -
Oct. 2015	5	9	9	0	$ 1,350	$ -
Nov. 2015	5	10	10	0	$ 1,500	$ -
Dec. 2015	5	11	11	0	$ 1,650	$ -
Jan. 2016	5	12	12	0	$ 1,800	$ -
Feb. 2016	5	13	12	1	$ 1,800	$ 150
Mar. 2016	5	14	12	2	$ 1,800	$ 300
Apr. 2016	5	15	12	3	$ 1,800	$ 450
May 2016	5	16	12	4	$ 1,800	$ 600
Jun. 2016	5	17	12	5	$ 1,800	$ 750

Jul. 2016	5	18	12	6	$ 1,800	$ 900
Aug. 2016	5	19	12	7	$ 1,800	$ 1,050
Sep. 2016	5	20	12	8	$ 1,800	$ 1,200
Oct. 2016	5	21	12	9	$ 1,800	$ 1,350
Nov. 2016	5	22	12	10	$ 1,800	$ 1,500
Dec. 2016	5	23	12	11	$ 1,800	$ 1,650
Jan. 2017	10	24	12	12	$ 3,600	$ 3,600
					$ 35,100	**$ 13,500**
The current portion of the obligation is $117,150 – $13,500 = $103,650						

P11-37. ***Suggested solution:***

Summary journal entries			
To recognize the flight-related revenue in 2018			
a.	Dr. Cash	10,000,000	
	Cr. Flight revenue		9,925,000
	Cr. Unearned revenue (award points)		75,000
To recognize reward point revenue in 2019			
b.	Dr. Cash	20,000	
	Dr. Unearned revenue (award points)	30,000	
	Cr. Award revenue		30,000
	Cr. Flight revenue		20,000
To recognize reward point revenue in 2020			
b.	Dr. Cash	15,000	
	Dr. Unearned revenue (award points)	22,500	
	Cr. Award revenue		22,500
	Cr. Flight revenue		15,000

Supporting computations and notes

- 7,500,000 miles are expected to be redeemed (9,375,000 × 80% = 7,500,000). This translates into 500 flights (7,500,000 / 15,000 = 500).

- 200 reward flights are redeemed in 2019. (200 / 500 × $75,000 = $30,000). A $100 service charge is levied for each award flight. (200 × $100 = $20,000)

- 150 reward flights are redeemed in 2020. (150 / 500 × $75,000 = $22,500). A $100 service charge is levied for each award flight. (150 × $100 = $15,000)

- To obtain the amount of reward revenue to recognize, the denominator is the number of miles expected to be redeemed rather than the number awarded.

- ($75,000 / 500 flights = $150), which is the value allocated to each flight expected to be awarded. From an accounting perspective this is the net amount. The gross cost of providing the flight minus the costs to be recovered equals the allocation of the award ($250 – $100 = $150)

P11-38. *Suggested solution:*

To provide for the expected liability settlement		
Dr. Lawsuit settlement expense	8,000,000	
Cr. Provision for liability settlement costs		8,000,000
Provision measured using the most likely outcome (80% probability of offer acceptance)		
To allocate a portion of the ticket sales proceeds to the award program		
Dr. Flight revenue	720,000	
Cr. Unearned revenue (award miles)		720,000
As the award portion of the flights has not previously been allowed for, an entry is required to reverse a portion of the ticket sales revenue from flight revenue to award revenue		
To recognize award point revenue in 2016		
Dr. Unearned revenue (award miles)	144,000	
Cr. Award revenue		144,000
(30,000,000 × 80% = 24,000,000) miles expected to be redeemed. (4,800,000/24,000,000 × $720,000 = $144,000)		

P11-39. *Suggested solution:*

a. A contingent liability is either i) a present obligation, the amount of which cannot be measured with sufficient reliability; or ii) a possible obligation. Possible obligations are amounts that may be owed depending on the outcome of future event(s). A contingent asset is a possible asset. Possible assets are amounts that may be due depending on the outcome of future event(s).

b. There are two factors that govern accounting for contingent liabilities: i) the likelihood of the outcome and ii) the measurability of the obligation. If the outcome is probable and the obligation is measurable, the entity provides for the obligation using the most likely outcome. "Probable" is defined as likelihood greater than 50%. If the outcome is probable, but the obligation cannot be reliably measured, or the outcome is only possible, then the entity does not provide for a liability. Rather, the entity discloses the details of the contingency in the notes to its financial statements. If the possibility of the outcome is remote, the entity neither provides for an obligation nor discloses the details.

c. The likelihood of the outcome is the sole factor that governs accounting for contingent assets. If the likelihood is virtually certain, the asset is provided for in the financial statements. If it is probable, the details of the contingency are disclosed in the notes to the financial statements. If the outcome is possible or remote, the entity neither provides for an asset nor discloses the details.

P11-40. ***Suggested solution:***

The terms "probable", "possible", and "remote" as they pertain to contingencies collectively describe the likelihood of a possible liability or asset being confirmed as a liability or asset. Probable is a likelihood of occurrence greater than 50%. Remote is not expected to occur, with the maximum likelihood being in the range of 5% to 10%. The likelihood of possible falls between probable and remote.

As accounting for contingent assets and contingent liabilities differs somewhat, they are discussed separately.

Contingent liabilities:
Whether a contingent obligation can be measured with sufficient reliability must also be considered, although IFRS suggests that it will be only in extremely rare situations that a potential obligation cannot be reliably measured. The spectrum of possible accounting treatments for contingent liabilities is detailed in the matrix below.

Contingent liabilities	**Obligation can be reliably measured**	**Obligation cannot be reliably measured**
Probable: 50%+	Provide for using expected value techniques	Note disclosure
Possible: 5–10% to 50%	Note disclosure	Note disclosure
Remote: <5 to 10%	Neither provide nor disclose	Neither provide nor disclose

Contingent assets:
Contingent assets are recognized in the financial statements only if realization is virtually certain. When realization is probable (50 %+), note disclosure is appropriate.

P11-41. ***Suggested solution:***

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

Dr. Other receivables (lawsuit)	100,000	
Cr. Lawsuit award		100,000

2. (B) The outcome is possible but not probable, so note disclosure is required.
3. (A) A $1,000,000 liability is provided for as the loss is probable and can be reliably measured. While the final settlement may be as low as $5 million or as high as $10 million, Canless is responsible only for the $1,000,000 deductible.

Dr. Environmental cleanup expense	1,000,000	
Cr. Provision for environmental cleanup costs		1,000,000

4. (A) The loss is probable and has to be provided for. The most likely outcome is used to determine the amount of the obligation based on legal counsel's best estimate of the amount required to settle the obligation. The midpoint of the range has been used as the most likely outcome as if the plaintiff is successful all payouts in the stipulated range are equally likely.

Dr. Contract settlement expense	1.100,000	
Cr. Provision for contract settlement costs		1,100,000
[($1,000,000 + $1,200,000) / 2]		

5. (A) The loss is probable and so the company must make a provision. The most likely outcome is used to determine the amount of the obligation based on legal counsel's best estimate of the amount required to settle the obligation. If Threlfall subsequently accepts the $100,000 offer, this is a change in estimate that will be dealt with prospectively.

Dr. Lawsuit settlement expense	200,000	
Cr. Provision for liability settlement costs		200,000
Provision measured using the most likely outcome (90% probability of $200,00 pay-out)		

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

P11-42. ***Suggested solution:***

The loss is likely and so the company must recognize a contingent loss for the minimum in the range less the net amount covered by insurance, and disclose the remainder in the notes to the financial statements.

Dr. Lawsuit settlement expense	1,500,000	
Cr. Lawsuit liability settlement costs		1,500,000
[$6,000,000 - ($5,000,000 - $500,000)]		

P11-43. ***Suggested solution:***

a. Assuming that the reporting company prepares its financial statements in accordance with IFRS
   1. (A) The loss is probable and has to be provided for. The most likely outcome is used to determine the amount of the obligation based on legal counsel's best estimate of the amount required to settle the obligation. The midpoint of the range has been used as the most likely outcome as if the plaintiff is successful all payouts in the stipulated range are equally likely.

Dr. Contract settlement expense	700,000	
Cr. Provision for contract settlement costs		700,000
[($600,000 + $800,000) / 2]		

2. (A) The loss is probable and so the company must make a provision. The most likely outcome is used to determine the amount of the obligation based on legal counsel's best estimate of the amount required to settle the obligation. The midpoint of the range has been used as the most likely outcome as if the plaintiff is successful all payouts in the stipulated range are equally likely. If Morton subsequently accepts the $200,000 offer, this is a change in estimate that will be dealt with prospectively.

Dr. Lawsuit settlement expense	250,000	
Cr. Provision for liability settlement costs		250,000
[($200,000 + $300,000) / 2]		

b. Assuming that the reporting company prepares its financial statements in accordance with ASPE
   1. (B) The probability of loss is 55% which is less than the 70% threshold commonly used in ASPE to determine whether payout is likely. Note disclosure is required.
   2. (A) The loss is likely and so the company must recognize a contingent loss for the minimum in the range and disclose the remainder in the notes to the financial statements.

Dr. Lawsuit settlement expense	200,000	
Cr. Lawsuit liability settlement costs		200,000

P11-44. ***Suggested solution:***

Financial guarantees are initially recognized at their fair value. ZSK must also disclose its $150,000 maximum exposure to the underlying credit risk.

P11-45. ***Suggested solution:***

Onerous contracts are obligations in which the unavoidable costs of fulfilling the contract exceed the expected benefits to be received. As the expected benefit may be greater than the current market value of the item, a contract to purchase assets for more than fair value is not necessarily onerous.

Onerous contracts must be provided for in the financial statements. The loss recognized equals the unavoidable costs less the expected economic benefit.

P11-46. ***Suggested solution:***

Economic analysis				
	Situation a		**Situation b**	
Expected economic benefit	10,000 × $3.20 =	$32,000	10,000 × $2.75 =	$27,500
Unavoidable costs	10,000 × $3.00 =	$30,000	10,000 × $3.00 =	$30,000
Profit (Loss)		$ 2,000		$ (2,500)
Result	Non-onerous contract		Onerous contract for which the expected loss must be provided	

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

Dr. Loss on onerous contract	2,500	
Cr. Provision for loss on onerous contract		2,500

P11-47. ***Suggested solution:***

Economic analysis				
	Situation a		**Situation b**	
Expected economic benefit	1,000 × $36.00 =	$36,000	1,000 × $45.00 =	$45,000
Unavoidable costs	1,000 × $40.00 =	$40,000	1,000 × $40.00 =	$40,000
Profit (Loss)		$ (4,000)		$ 5,000
Result	Onerous contract for which the expected loss must be provided		Non-onerous contract	

a. The expected economic benefit is less than the unavoidable costs and must be provided for.

Dr. Loss on onerous contract	4,000	
Cr. Provision for loss on onerous contract		4,000

b. While Waterloo has contracted to pay more for the silica than the current market price, it remains that the expected economic benefit exceeds the unavoidable costs. The contract is thus non-onerous and does not need to be provided for in the financial statements.

P11-48. ***Suggested solution:***

1. This contingent liability does not need to be provided for as it is only possible (20%–30%), not probable (>50%). Note disclosure of the underlying circumstances is required.
2.

Dr. Cash	5,000	
Cr. Liability for financial guarantee		5,000

Calgary must also disclose its $500,000 maximum exposure to the underlying credit risk.

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

4. The loss is probable and has to be provided for. The most likely outcome is used to determine the amount of the obligation based on legal counsel's best estimate of the amount required to settle the obligation.

Dr. Loss on lawsuit (breach of contract)	100,000	
Cr. Provision for lawsuit settlement costs		100,000
Provision measured using the most likely outcome (50% probability of $100,000 award)		

5. A journal entry is not required. Rather, the $5,000,000 must be disclosed as a current liability in the 2018 financial statements as renewal was not effected before year-end. The fact that the bank agreed to renew the loan after year-end, but before the statements were authorized for issue, is disclosed as a non-adjusting event in the notes to the financial statements.

P11-49. ***Suggested solution:***

1. The inventory is recorded at cost and a payable established for the Canadian dollar equivalent of the obligation.

Dr. Television inventory	9,900	
Cr. Trade accounts payable		9,900
(20 × US $500 × C$0.99/US$1.00)		

2. A journal entry is not required. The solvent is a relatively low cost component of the chromatography process. While the market price is now much lower than the price previously contracted for, it is inferred that the expected benefits to Regina still exceed the unavoidable costs. Accordingly, the contract is non-onerous and does not need to be provided for in Regina's financial statements.
3. A journal entry is not required. The loan may be reported as a non-current liability as the grace period extends 12 months after the balance sheet date.
4. The loss is probable and has to be provided for. The most likely outcome is used to determine the amount of the obligation based on legal counsel’s best estimate of the amount required to settle the obligation.

Dr. Loss on lawsuit (customer injury)	300,000	
Cr. Provision for lawsuit settlement costs		300,000
Provision measured using the most likely outcome (60% probability of $300,000 award)		

5. This contingent liability does not need to be provided for as it is only possible (10%–32%), not probable (>50%). Note disclosure of the underlying circumstances is required.

P11-50. ***Suggested solution:***

1. A journal entry is not required as the outstanding amount of the liability has not changed. From a reporting perspective, the loan will be reported as a non-current obligation as the lender agreed to a 12-month grace period before year-end.
2. IFRS allows for short-term, zero-interest-rate notes to be measured at the original invoice amount if the effect of discounting is immaterial. This is the case here as the note is due in 30 days and the imputed interest amount is immaterial (about $30).

Dr. Storage bins	20,000	
Cr. Notes payable		20,000

3. While Port Mellon has contracted to pay more for the phosphorus than the year-end market price, it remains that the expected economic benefit exceeds the unavoidable costs. The contract is thus non-onerous and does not need to be provided for.
4. This is a third-party reward. As Gander is not an agent of the airline, revenue and expense pertaining to the award are separately recognized.

May 24, 2017	Dr. Cash	25,000	
	Cr. Parking revenue ($25,000 – $1,000)		24,000
	Cr. Award revenue (50,000 × $0.02)		1,000
May 24, 2017	Dr. Award expense (50,000 × $0.02)	1,000	
	Cr. Cash (50,000 × $0.02)		1,000

5.

Dec. 31, 2017	Dr. Interest expense	256	
	Cr. Accrued interest payable		256
	$20,000 × 6% × 78 / 365 = $256 (rounded)		

N. Mini-Cases

Case 1: Cool Look Limited. *Suggested solution:*

This memo presents an analysis of the going-concern assumption as it relates to this case and discusses the accounting issues that need to be resolved before the financial statements can be finalized.

Memo to: Audit file

From: CPA

Subject: Accounting issues for discussion with the partner in charge of the CLL audit

Going concern

There is a need to assess the going-concern assumption in the 2015 audit of CLL as IAS 1 requires that management shall make an assessment of an entity's ability to continue as a going concern.

CLL's bank has extended CLL's credit up to February 29, 2016, at which time it reserves the right to call its loan if the covenants are not met. Being in breach of covenants in and of itself does not automatically result in CLL not being a going concern. However, there are a number of other factors that do suggest CLL is not a going concern. CLL has lost money for at least the past two years. It also has stretched its accounts payable from just under $1 million a year ago to over $2.3 million. It currently cannot afford to upgrade and refit its equipment, and is not maintaining its equipment or maintaining its insurance coverage. Furthermore, the board passed a resolution to temporarily delay remitting taxes until cash flows improved. These points indicate serious liquidity problems.

The financial ratios are not currently met by CLL. Before making any adjustments for audit findings, the November 30, 2015 statements show CLL is onside on one of the two ratio requirements. The current ratio is 1.7:1, which is more than the minimum 1:1 allowed. However, reclassifying the long-term debt as a current liability (a possibility discussed later in my memo) would reduce the current ratio to 0.4: 1, which is less than the bank's requirement. It is also possible that the bank will not consider the $500,000 loan to Martin Roy in its current-ratio calculation, which would reduce the ratio further. In addition, the debt-to-equity ratio is 86%, while the bank is asking for a maximum debt-to-equity ratio of 80%. This ratio will require improvement in order to meet the covenants set out by the bank in its November 1 letter.

We need to discuss the extent of the problem with management. Evidently management and the Board are concerned about the cash position since they have taken steps to reduce spending. But they also increased their risk exposure by delaying payments and cancelling the insurance. We need additional information before concluding on the validity of the going-concern assumption. For example, we need to see future cash flow forecasts, sales forecasts, and future sales contracts.

There are a number of positive factors that suggest CLL is a going concern. CLL has $1,094,000 cash on hand as of November 30. If the equipment can be refitted using that cash in the next three months, CLL may remain a going concern. Also, CLL still has a positive equity, and our review of the minutes shows that the company has a new, large contract. These factors suggest that CLL remains a going concern, despite the possibility of the bank calling its loan any time after February 29, 2016.

Although further investigation is required, it is probable that the company will be judged to be a going concern given the positive factors identified. If there are material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern, the company is required to disclose those uncertainties.

Accounting issues requiring resolution

Capital assets
CLL has $1.3 million (book value) of capital assets that are apparently not usable. A determination must be made as to whether an impairment loss should be recorded. The question is whether these assets have been abandoned by CLL or temporarily stored. Management will likely argue that the assets are simply being stored and that each asset's value is not impaired because refitting the assets makes them usable again. However, the assets are not currently being used, and CLL may not have the immediate financial resources to refit them. Therefore, the assets' recoverable value may be less than its carrying amount. The assets should be tested for impairment.

The first question to resolve is which Cash Generating Unit (CGU) or units the dormant equipment belongs to. IFRS defines CGUs as the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets. Based on the information I have, I assume the dormant equipment can be treated as a CGU. However, these unused assets could also be considered as the larger asset group of all CLL's equipment.

After determining an appropriate CGU(s), the next step is to determine the recoverable amount of the CGU(s). If the book value of the equipment is greater than the recoverable amount, then it should be written down to the recoverable amount. The impairment loss is applied firstly to goodwill, if any, pertaining to the CGU, but this does not apply here. With respect to the idle equipment, it is possible that it has some value, due to the fact that refitting can be performed on the equipment to make it usable again. This aspect needs to be explored further so as to arrive at an accurate estimate of the CGU's recoverable value.

Inventory transaction
Finished goods inventory at a cost of $565,000 was shipped by CLL to Big Bargain Clothing (BBC), a national retail clothing outlet store, on November 29, 2015. The shipment was recorded as sales revenue of $1 million, generating a gross profit of $435,000.

BBC can return unsold inventory to CLL at any time after February 1, 2016. This suggests that the transaction is more like a consignment. Goods on consignment should not be recognized as sold until purchased by the final customer. At this time, we have no information as to whether BBC has sold any of the finished goods inventory. However, given that the inventory was shipped on November 29, it is very unlikely that any would have been sold by the November 30 year-end. In addition, revenue-recognition standards (IAS 18) indicate that a right of return may preclude recognition of revenue. Given the special nature of the arrangement (meaning that CLL has no experience with this type of transaction and so will not be able to reasonably estimate returns), it is inappropriate for CLL to recognize the revenue.

Secured operating line of credit
The secured operating line of credit is classified as long-term debt. This classification is in doubt. Until now the bank has waived its right to call the loan, justifying the long-term classification. Now that the December 1 date is passed (and considering the letter from the bank indicating that it may in fact call the loan if certain ratios do not improve), it is clear that the loan should be classified as current. Also, IAS 1 addresses situations where an entity would be in violation of debt covenants at the balance sheet date. The fact that CLL is in clear violation of covenants now and is unlikely to be able to correct the situation by February 29, 2016, provides additional support for treating the loan as current.

Tax/GST liabilities
The Board passed a resolution to temporarily delay remitting taxes until cash flows improved. We need to assess the amount of the unrecorded liabilities, including interest and penalties, and make sure they are recorded in the financial statements.

Case 2: Earth Movers Ltd. ***Suggested solution:***

Dear Mr. Donnelly:

You asked us to determine the amount of financing that Earth Movers Ltd. can expect to obtain from S&L Bank. The bank intends to base its loan on EML's audited financial statements.

This report first explains our assumptions and also the adjustments we had to make to EML's unaudited balance sheet in order to calculate the amount of financing available. You should examine these assumptions carefully, since you may or may not agree with them. As you requested, we have explained the accounting policies that caused us concern and have stated how they should be changed.

The report then sets out our calculations and their results. We need additional information from you before we can make final calculations. Further, you should be aware that the bank may make assumptions and adjustments that differ from ours and may, therefore, arrive at a different loan figure.

By our preliminary calculations, S&L Bank can be expected to lend you approximately $2.6 million, which will be sufficient to repay EML's existing bank loan but not sufficient to repay your loan to EML.

We will contact you to arrange a meeting to discuss our report and obtain the information we need.

Yours truly,

WB, Chartered Professional Accountants

<u>Draft report to Earth Movers Ltd. (EML) on financing available from S&L Bank</u>

Basis of calculations: the financial statements
The amount of financing from S&L is calculated using the figures reported in the audited financial statements, which have to be in accordance with International Financial Reporting Standards (IFRS). Before the financing can be calculated, EML's statements must be adjusted. Please bear in mind that the financial statements have not been audited; therefore, the account balances may change. In that case, the amount of financing available will also change.

IFRS permits choices in the selection of certain accounting policies. When possible, EML should select policies that will improve the working capital ratio and the capital assets, both of which are used in the bank's formulae to calculate the amount of financing available. At the same time, the financial statements should not mislead the bank, the primary user. Moreover, existing accounting policies can be changed only if it is either required by IFRS or results in the financial statements providing reliable and more relevant financial information.

Working capital ratio
The first step in calculating the amount of financing is to determine the working capital ratio since it determines which of the bank's two formulae is to be used. Formula 2 requires EML to have a higher working capital ratio than Formula 1 does, but is the more favourable formula to use since it results in a larger loan.

The working capital ratio is the ratio of current assets to current liabilities. Calculating it is straightforward, but problems can arise in determining precisely what should be classified as current assets and as current liabilities. Because this is open to interpretation, any loan agreement that EML signs with S&L Bank should specify the formula used for calculating the loan and the EML assets and liabilities that the bank accepts as current. In addition, the nature of the assets should be clearly described in the agreement.

Our calculation of the working capital ratio excludes spare parts inventory since, contrary to what is reported on the EML balance sheet, it is not a current asset. This asset relates to the earth movers that are included in equipment. Even though the spare parts inventory is excluded from the calculation of the working capital ratio, it will increase the capital assets on which money will be lent.

The income taxes payable, also listed on the EML balance sheet, are excluded from the calculation of working capital. This amount, while current in nature, is a personal liability rather than a corporate liability. Its exclusion improves the working capital ratio.

Accounting policies: underlying assumptions or adjustments
To prepare the appropriate balance sheet figures, it was necessary to make some assumptions about what accounting policies to apply. Some estimates were also necessary. These are explained below.

Accounts receivable
Accounts receivable include an amount of $85,000 in disputed invoices, relating to the operations of a gravel pit. Unless the owner of the gravel pit has given an assurance that the amount will be paid, we are assuming for the purposes of this report that EML will not be paid. Part of the amount or the full amount should be written off your books. If the probability of collection cannot be determined, the full amount should be written off. If an agreement is reached, then the receivable will stay on the books.

Amount owed to the previous auditor
The accounts payable includes an amount of $146,000 owing to Fred Spot for services rendered over a period of three years. Has he been pressing for collection? If not, it may be possible to persuade Mr. Spot to reduce the amount. You should settle this billing with him and reach an amount agreeable to both parties, thereby decreasing the accounts payable and increasing the working capital. We have made no assumptions concerning the accounts payable and will wait to hear from you.

Parts of scrapped earth movers held for resale—$60,000
If there are buyers for the scrapped earth movers, and providing that the requirements of IFRS 5 are met, then this item should be carried on the balance sheet as a current asset. It would then be segregated from equipment as "non-current assets held for resale." This treatment will have a favourable impact on the working capital ratio and the amount of financing available will increase. The drawback is that these assets do not fall within S&L's funding formula, although you may be able to negotiate something in this respect.

Spare parts inventory
The spare parts inventory, which apparently consists solely of wheels, appears to be overvalued. First, only two earth movers out of a fleet of 21 use size 250H wheels. Second, the wheels are replaced infrequently. Thus EML seems to have more 250H wheels on hand than are needed in the ordinary course of business. In addition, the average cost of 350H wheels is $30,000, while that of 250H wheels is $81,429. The carrying value of equipment is impaired if the carrying amount of the assets exceeds the recoverable amount, which is the higher of an asset's fair value less costs to sell and its value in use.

We have arrived at a value for the 250H wheels that we consider reasonable as follows. The one wheel that was in inventory before the additional six were added was carried at $20,000. (Book value of $550,000 was transferred on the addition of the six wheels, raising the total book value to $570,000. The difference of $20,000 is presumably the amount at which the single original wheel was carried.) Using the $20,000 as the appropriate value for a 250H wheel, we have valued the seven 250H at $140,000. The amount on the balance sheet should be revised to show this amount.

Besides the overvaluation of the wheels, we had to consider the question of whether the spare parts should be classified as inventory or as equipment. We decided to classify the spare parts as equipment. Inventory by definition is merchandise held for resale or supplies to be consumed in the production process, which is not the case here.

As noted earlier, EML and the bank must agree on definitions to be included in the agreement—for example, the definitions of such terms as "inventory" and "equipment." Their definition affects the amount of financing available since the bank proposes to lend money at different percentages on these two categories (for instance, it will lend 30% of the value of inventory under Formula l). In addition, inventory is a current asset and is therefore included in the calculation of the working capital ratio. Equipment, however, is a long-term asset, so it is excluded from the calculation of the working capital ratio.

Capital assets
A gain of $90,000 from an insurance claim was recorded. The asset appears to have been fully depreciated since a gain was recorded for the total amount to be received from the insurance company. If the asset was not fully depreciated, then the net book value of the asset should be written off, which would reduce the amount of the gain to be recorded. If you intend to repair the asset you should either accrue an amount payable for the repair or reduce the receivable by $90,000. Reducing the value of the receivables will reduce the amount of financing available.

A sum of $15,800 was spent to make the earth mover operational. This amount should be capitalized to equipment since the expenditure will have future benefit. This will result in an increase in the amount of financing available.

The cost of cleaning and painting the shop should be considered a regular maintenance expense and cannot be capitalized.

The Eckleforth site has a remaining life of two years and is unlikely to be offered to the City of Eckleforth in the current year. Therefore, the Eckleforth site should not be classified as a current asset.

Landfill sites
It was necessary to decide whether landfill sites should be classified as land and included in the calculation of the financing. The landfill sites should be recorded at the lower of the net recoverable amount and the net carrying value. EML's plan to offer the Eckleforth site to the City of Eckleforth suggests that landfill sites may have no market value and may even have a negative value since the cost of cleaning up the Eckleforth site is higher than its net book value. We have assumed that the landfill sites would not be included as land. In the case of the Eckleforth site, even if it were included, its value would be nil.

Funds due to shareholder
Our biggest concern was how to classify the amount owed to you by EML. You have made it very clear that you want EML to repay the loan, which means that this debt is current for the company, i.e., will be paid within one year. If this amount is considered current, then the working capital ratio will be lower than 1 and no financing will be available. In order to obtain the financing you need, repayment of the amount owed to you will have to be postponed until the following year. The bank will want a written commitment from you stating that you will not ask for the repayment of the debt within a year. We have assumed that you will agree to this condition in order to obtain the financing.

Other
Income taxes payable are your personal expenses and should not be included on EML's balance sheet. This elimination results in a more favourable working capital ratio.

The current portion of long-term debt is a current liability; however, the terms of S&L's offer specify that the working capital ratio excludes any financing from the bank. Accordingly, we have excluded this amount for the purpose of determining the working capital ratio.

Calculation of financing available
We have restated the balance sheet in accordance with the preceding analysis, as follows:

	As stated in unaudited balance sheet, June 30, 2018	Revised under the given assumptions
Cash	$ 84,000	$ 84,000
Accounts receivable	585,000	410,000
Non-current assets held for resale	0	60,000
Spare parts inventory	907,000	477,000
Land, building, and equipment	2,759,000	2,705,100

As noted earlier, these numbers are preliminary since an audit has not been performed and the numbers could change after an audit is performed. Furthermore, you may disagree with some of the assumptions we have made, and further information is needed to confirm some of the assumptions.

Financing available
On the basis of the revised balance sheet, the working-capital ratio is 1.60:1 (the current assets being $554,000 and current liabilities $347,000). We have not included taxes payable or the current portion of long-term debt in the calculation of the ratio. Even with the revised numbers, including the amount due to you from EML would reduce the ratio to less than 1.00.

Formula 2 should be used to calculate the amount of financing available (000s).

- 80% × AR (410) =	$ 328
- 70% × capital assets (477 + 2,705.1) =	2,227
- Total available	$2,555

With financing of this amount, EML will be able to repay the loan to the Dominion Royal Bank but will not have enough to repay the loan due to you.

The actual amount that S&L Bank is willing to lend EML will depend on the Bank's own definitions of assets and liabilities. The Bank may disagree with the assumptions and policies we have used in defining assets and liabilities. If the bank's definitions differ from ours, its conclusion will differ from ours.

Sensitivity analysis
Since the numbers may change, we have made calculations using some changed assumptions. The first scenario includes the $90,000 from the insurance claim, since EML might not repair the truck. The second includes $290,000 for the Banbury site but excludes the Eckleforth site since it has no value.

1. If we include the amount of $90,000 receivable from the insurance company, the amount of financing you can expect to receive will increase by $63,000 ($90,000 × 70%) under Formula 1 and by $72,000 ($90,000 × 80%) under Formula 2. Under neither formula will the amount received from the bank cover the amount owed to you.
2. If the Banbury landfill site is included in the calculation, the loan would increase by $145,000 ($290,000 × 50%) or $203,000 ($290,000 × 70%). This scenario is very unlikely to materialize. No provision for site restoration costs has been made for this site, and the bank would probably question the value assigned to the site.

Before you begin negotiating a loan agreement with S&L, you should consider whether a lower interest rate is more beneficial to you. The existing loan is long term and is for 10 years. What S&L is offering you is partly a short-term loan and partly a long-term loan. S&L's long-term loan could be recalled as soon as the next set of financial statements is available. The S&L Bank has the right to recall the loan based on the audited financial statements. You could be put in the same situation next year, i.e., looking for financing again.

Case 3: Lisa's Insurance Services Ltd. ***Suggested solution:***

Analysis and recommendations

1. The liability to the vendor will be recorded at $17,589, determined as set out below. The accrued interest of $682 will be reported as a current liability, while the principal portion of $16,907 will be reported as long-term debt.
   - Present value of the note at origination using a BAII PLUS financial calculator: 3 N; 8 I/Y; 20000 FV; 400* PMT; CPT PV PV = –16,907 rounded. The computer asset will be recorded at $16,907. *$20,000 × 2% = $400
   - Accrued interest to December 31, 2017 = $16,907 × 8% × 184 / 365 = $682 (rounded)
   - The liability to be recorded = $16,907 + $682 = $17,589.
2. The key word in the facts given in the question is "possible." As legal counsel advises that the outcome is possible, rather than probable, a liability is not provided for. Rather, the nature and details of the lawsuit should be disclosed in the notes to the financial statements. Had counsel determined the outcome to be probable, an obligation would be provided for using present value techniques.
3. IFRS 9 paragraph 5.1.1 requires that the guarantee be initially reported at its fair value. The fair value considers the amount of the guarantee, the prevailing discount (interest) rate, and the probability of default. Subsequently the guarantee is measured at the higher of the best estimate to settle and the remaining provision recorded in the financial statements. IFRS 7 requires that LISL disclose the nature of the guarantee including the maximum risk exposure ($100,000).
4. Because LISL was granted the waiver before year-end, the term loan with the bank may be reported as a non-current liability. Had the waiver been received after year-end but before the statements are issued, the liability must be presented as a current obligation with the details of the grace period disclosed.

Case 4: Current liabilities and contingencies. ***Suggested solution:***

To: Mr. Robert Watt, CEO
From: Ranjit Sidhu, CFO
Date: February 15, 2017
Re: Contemplated changes to the company's warranty and reward programs

As requested, I have analyzed the changes that you have been considering to the company's warranty and reward programs. My findings follow:

Warranties: Revenues from the warranties sold separately are deferred and recognized over the three years of coverage. If the warranties are bundled with the product there will be two effects.

- The full price of the warranty will be recognized as revenue in the year of the sale. These revenues will be partially offset by the expected cost of servicing the warranty during the coverage period; however, this provision will be lower than before as it no longer includes unearned profits.
- We currently sell warranties covering about 70% of our products. In a bundled sale, this will increase to 100%. Assuming that our sales levels of appliances remain unchanged—which, as discussed below, is by no means certain—then revenues and profit will increase incrementally from the (bundled) sale of the additional warranties.

The net effect on the income statements will be that the net profits from the warranties will be recognized in the year the warranties are sold, rather than over the three-year warranty period. The additional after-tax profit will flow through to retained earnings.

Reward program: Under the current program, because the rewards are supplied by our company, the revenues from sales to the retailers are considered “multiple deliverables”. Thus, we estimate the value of the future benefits the retailers are entitled to, and this portion of the revenue is deferred to the following year. If the program is changed such that the rewards will be provided by a third party, then in the year of the sale, the full amount of the sale will be recognized as revenue at the time the appliances are delivered to the retailer. This increase will be offset, however, as the cost of the rewards the retailers are entitled must now be expensed in the year of sale. The change will immediately impact the financial statements.

All revenue will be realized at time of sale, rather than deferring a portion to the following year, these incremental revenues will be offset by the expense for the cost of the reward program. Net income and hence retained earnings will be largely unaffected. The contemplated change will also impact the balance sheet. Currently a provision for unearned revenues is established for the expected future benefits to be provided to the retailer. Under the new approach a liability will not normally be recorded. Rather, the cost of the program will be remitted to Rewards Plus on an ongoing basis, reducing our cash position.

As the analysis above shows, under both proposed changes all the revenue is recognized up front. Thus, if these changes are implemented next year, in this transition year, gross revenues will increase. In the case of the warranties it is due to the combination of the acceleration of earnings on the warranty product and higher revenue for the additional warranty sales, and in the case of the rewards program it is because the reward portion of the revenues will no longer be deferred to the following year.

The foregoing analysis only examines the accounting effects of the proposed changes. These changes can have unintended economic consequences that warrant careful consideration. For example, a change in the way warranties are sold may negatively impact appliance sales as the customer will no longer be able to choose whether or not to purchase a warranty. Similarly, retailers may not be receptive to the proposed amendments to the reward program as they may prefer cash discounts to rewards of products and/or services that they may not need. Moreover, the change to an external rewards supplier will initially negatively impact our cash position. Lastly, for the most part the apparent increase in revenues does not reflect real growth, but rather the effect of changes to the timing of revenue recognition. The increase in sales (and in profits) is largely a one-time event in the transition year and is not sustainable on an ongoing basis.

I will be pleased to discuss this with you at your convenience.

CHAPTER 11
Current Liabilities and Contingencies

CPA COMPENTENCIES ADDRESSED IN THIS CHAPTER:

1.1.2 Evaluate the appropriateness of the basis of financial accounting (Level B)
1.1.4 Explains implications of current trends and emerging issues in financial reporting
  a. emerging trends in accounting standards and recent updates
1.2.1 Develops or evaluates appropriate accounting policies and procedures (Level B)
1.2.2 Evaluates treatment for routine transactions (Level A)
  g. Provisions, contingencies, and current liabilities
  k. Financial instruments
  p. Foreign currency transactions
1.3.1 Prepares financial statements (Level A)
1.3.2 Prepares routine financial statement note disclosure (Level B)
1.4.1 Analyzes complex financial statement note disclosure (Level C)

LEARNING OBJECTIVES

11-1. Describe the nature of liabilities and differentiate between financial and non-financial liabilities.
11-2. Describe the nature of current liabilities and account for common current liabilities including provisions.
11-3. Describe the nature of contingent assets and liabilities and account for these items.
11-4. Describe the nature of commitments and guarantees and apply accrual accounting to them.

OVERALL APPROACH

This chapter serves two roles. The first is an overview of liabilities, and the second is detailed coverage of current liabilities, contingencies, and commitments. Chapter 12 then deals with non-current financial liabilities, while later chapters cover other more specialized topics that partially involve liabilities (complex financial instruments, accounting for income taxes, pensions, leases).

KEY POINTS

Overview of liabilities: Section B (pp. 502-505) discusses the definition, recognition, classification, and measurement of liabilities. Here, classification precedes measurement because the method of measurement depends on the classification of the particular liability.

The definition of a liability was first introduced in Chapter 2 as part of the conceptual framework. As it will have been a considerable length of time since students covered Chapter 2, it is important to review the three essential characteristics of a liability (a present obligation, arising from past events, and future outflow of economic benefits). It is useful to compare these characteristics with those that define an asset.

The recognition of liabilities, consistent with other financial statement elements, depends on the ability to reliably measure the liability. Reliable measurement does not require certainty—liabilities can be recognized even if they are uncertain in amount or timing.

It is necessary to distinguish financial from non-financial liabilities because the measurement bases may differ. Financial liabilities are a type of financial instrument. IFRS requires that some financial liabilities be measured at their fair value rather than amortized cost.

As previously discussed in Chapter 3, the balance sheet (statement of financial position) usually uses the current / non-current presentation. Presentation by liquidity is rare (e.g., for financial institutions) and outside of what students would be expected to know and apply in intermediate accounting. Those liabilities maturing within one year of the balance sheet date are current; any fair value through profit or loss (FVPL) financial liabilities would also be presented as current.

The measurement of liabilities depends on their classification.

- Financial liabilities at FVPL – measure initially and subsequently at fair value. As noted above, these liabilities are outside of what students are expected to know, so they not covered in further detail.
- Other financial liabilities – measure initially at fair value minus transaction costs; subsequent measurement at amortized cost using the effective interest rate method. Covered in more detail in Chapter 12 and also discussed in Chapter 7.
- Non-financial liabilities – measure according to their nature. When the difference between the present value of future cash flows and the nominal value is material, use present value to measure the liability. Additional coverage follows in the next section.

Current liabilities: Section C covers a range of current liabilities. The eight examples are not comprehensive but do capture the most commonly encountered items.

1. Trade payables should be familiar to students. Two issues require further discussion:

   a. The concept of "cut off". Cut off refers to ensuring that all obligations entered into during a reporting period are properly recognized in the correct period. Cut off is an important concept and is pervasive across all elements of the financial statements. Incorrect cut off can cause errors or omissions in reporting. Some examples are:

- Sales invoices recognized at year end but goods do not ship until the beginning of the next fiscal period. This will overstate sales and accounts receivable.
- Failure to accrue expenses in the current period that have been incurred but not yet paid. This will understate expenses and accounts payable.
- Failure to record purchases for goods received. This will understate accounts payable and inventory.

b. The difference between the gross and net methods of recording cash discounts. Although the net method is more conceptually sound, the gross method is more commonly used. Businesses can justify using the gross method based on the cost-benefit and materiality constraints. Some students may recall that the mirror image of this issue was covered in Chapter 5 on accounts receivable. Also similar to accounts receivable is the fact that trade payables are not usually discounted for the time value of money due to the relatively high volume of transactions and the low amount of interest that would be imputed.

2. Common non-trade payables are other short term obligations that are indirectly related to the normal business activities of an organization. These include, but are not limited to: sales taxes payable, income taxes payable, dividends payable and royalty fees payable. Some specific issues to note about these payables follow.

a. Sales tax liabilities are classified as non-financial liabilities because they are legislated and not contractual. There is a risk that discussion here can become complicated because of the diversity of sales tax regimes in different provinces, and the technical details of the tax rules. It is therefore important to focus on the *accounting* for these taxes, not the specific tax rules. The important point to note is that an enterprise merely acts as an agent of the government, so that any taxes charged on sales made to customers are the property of the government and payable to it. On the purchases side, GST/HST paid on inputs are refundable to the enterprise and are therefore recorded as GST/HST recoverable. In contrast, PST paid is generally not recoverable. (PST is not payable on goods purchased for resale, while PST on goods not for resale becomes part of the cost of the items.) Page 508 discusses some of the complexities that can arise when accounting for sales taxes.
b. Income taxes payable are classified as non-financial liabilities also. Income taxes will be covered in more detail in Chapter 16.
c. Dividends payable occur when *cash* dividends are *declared* but not yet paid. The payable will normally be classified as current and the obligation only arises when dividends are declared, no amounts are accrued for cumulative preferred dividends in arrears. Stock dividends do not give rise to a liability and can be revoked by the board of directors before issuance.
d. Royalty fees arise from contractual obligations in a franchise agreement; therefore, unpaid royalty fees owing represent a current liability.

3. A note payable is distinct from trade payable by whether it is supported by a written promise to pay (i.e., a promissory note). Because of the lower frequency of these transactions and related record keeping costs, and the larger amount of interest that is typically expected, we generally record notes payable at discounted present value. However, enterprises often ignore immaterial amounts of interest on notes with very short durations (90 days or less). Interest bearing notes are initially recognized at the fair value of the consideration received and non interest bearing notes are measured at discounted present value. This section keeps the discussion of discounting at a simple level by assuming that the stated rate on the note is the same as the market rate. Differences in rates are left to the coverage of long-term debt in Chapter 12.

4. Credit (loan) facilities (e.g., line of credit) are commonly used to manage seasonal fluctuations in cash flows and balances. Recording the amount owed is straight-forward; the issue here relates to the disclosures required to detail the credit facilities available to the enterprise.

5. Warranties can be either a part of a product, or sold separately. The latter was covered in Chapter 4 on revenue recognition, so the focus here is on the former (manufacturers' warranties). Warranties are a type of contingency, which is discussed more thoroughly later in the chapter, because the outflow of resources depends on the outcome of future events (i.e., the product malfunctioning during the warranty period). Because the likelihood of loss is probable, and the amount can be reasonably estimated, IFRS treats warranty costs as a type of provision. The amount of the provision requires the use of expected value techniques (e.g., weighted average). Where the warranty obligations are deemed immaterial, the costs can be expensed as incurred.

6. Deferred revenue is a liability that was previously covered in Chapter 4 on revenue recognition. If the deferred revenue relates to a simple promise to deliver goods or services at a later date, then the accounting is fairly straight-forward. However, there are more complex examples of deferred revenue, such as frequent flyer miles, discussed next.

7. Customer incentives. Many companies offer various incentives to customers to purchase their products and services. These incentives may be in the form of customer loyalty programs, premiums, coupons, and rebates.

a. Customer loyalty programs give rise to deferred revenue. These loyalty programs involve the initial delivery of the primary product, plus a promise of future goods or services. Depending on who provides the future goods or services, the accounting differs. If a third party supplier is involved, than the reporting entity simply records an expense for the amount it needs to pay the third party for the loyalty points. If the reporting entity itself supplies the rewards, then it must treat the transaction as having multiple deliverables: those for the initial sale and those for the future delivery of rewards.
b. Premiums are goods and services that can be purchased by customers by exchanging "points" earned from past purchases. Discount vouchers (coupons)

entitle a customer to a discount off the retail price. Rebates require a customer to apply for a refund on a retail purchase. Premiums are accounted for similar to customer loyalty programs in that the initial sales represent a multiple deliverable. Measurement of the liability for the premium references the value to the customer, not the cost to the entity. Measurement of coupon and rebate liabilities is similar to the accounting for warranties. Where management's initial estimates prove incorrect, changes to the estimates are treated prospectively.

8. Other current liabilities. There are many other types of current liabilities, including certain obligations to employees. Some liabilities that warrant special consideration given their unique characteristics are:

a. Obligations denominated in foreign currencies should be translated into the functional currency (usually Canadian Dollars) at the transaction date, and then revalued at the endo of a period using the exchange rate at that time. Any resulting gain or loss flows through income.

b. Maturing debt to be refinanced and non-current debt in default create some interesting reporting issues. Exhibit 11-16 (p. 523) summarizes the treatments. The reporting outcomes depend on whether the enterprise obtains the renewal or grace period prior to (i) the year-end or (ii) the financial statement approval date.

Contingencies: Section D's coverage of contingencies takes a more fundamental approach to the topic than a simple interpretation of the standards. The reason is that the standards in IFRS relating to contingencies is convoluted and uses terminology that differs plain English and from that used in ASPE. IFRS defines contingent assets and liabilities, while ASPE defines contingent gains and losses. Confusingly, IFRS defines a contingent asset or liability based on the accounting outcome rather than its nature; contingent assets and liabilities are essentially those that are *not recognized* as assets or liabilities, *but which require disclosure* as a possible asset or liability.

To avoid the conflicting technical wording in the two sets of standards, the chapter uses the plain-English terms "contingencies," "contingent outflows," and "contingent inflows." For each of contingent outflows and contingent inflows, the two criteria of likelihood (remote, possible, probable) and measurability can then be applied. The result for outflows is the 2 × 3 matrix in Exhibit 11-18 (p. 525). The result for inflows is simpler: recognize if virtually certain and measurable; disclose as contingent asset if probable.

Another significant difference between IFRS and ASPE are the terms used for the upper category of likelihood: IFRS uses "probable" meaning >50% while ASPE uses "likely," which is usually interpreted to mean >70%.

Exhibit 11-19 (p. 526) provides accounting treatments for contingent outflows. It is important to note that uncertainty exists when estimating contingent liabilities and many other types of liabilities.

Commitments and guarantees: A commitment requires an enterprise to do something in the future. We can think of a guarantee as a contingent commitment, since a future adverse event must occur before action is required from the enterprise providing the guarantee. Commitments and guarantees generally require disclosure. A commitment is not recognized as a liability because it is a mutually unexecuted contract (or “executory contract”), unless the commitment involves an onerous contract. An onerous contract is one in which the unavoidable costs of fulfilling the contract exceed the benefits expected to be received (i.e., it will result in negative net outflows from the enterprise). An enterprise with an onerous contract must recognize the expected loss.

USE OF END-OF-CHAPTER PROBLEMS AND CASES

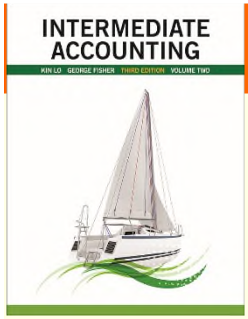
In addition to lectures, discussion of some of the end-of-chapter problems and cases will help students apply the concepts. The following table identifies the suggested problems and cases that could be used in class, as well as other suggested problems for homework assignments. (Depending on the time allocation between lectures and examples, it may not be feasible to cover all of the suggested items.)

Table 11-1:
Summary of learning objectives, chapter content, and suggested problems and cases

L.O. number	Learning objective	Pages	Suggestions for in-class discussion	Suggestions for assignments
11-1.	Describe the nature of liabilities and differentiate between financial and non-financial liabilities.	502-505	P11-2 P11-3	P11-5
11-2.	Describe the nature of current liabilities and account for common current liabilities including provisions.	505-523	P11-6 P11-18	P11-8 P11-15 P11-38
11-3.	Describe the nature of contingent assets and liabilities and account for these items.	524-530	P11-38	P11-41
11-4.	Describe the nature of commitments and guarantees and apply accrual accounting to them.	530-531	P11-48	P11-50
--	Integrative		Case 1 Cool Look Limited	Case 2 Earth Movers Ltd.

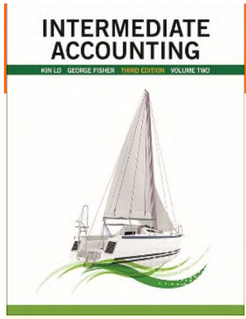
Cool Look Limited involves a (simulated) company that will potentially breach bank covenants and as a result it would need to repay a significant bank loan. The student, playing the role of the auditor, must apply professional judgment to conclude how various transactions and accounts should be reflected in the financial statements. The accounting potentially affects whether the company is able to meet the bank covenants.

Case 2 involves another simulated company that has to procure significant refinancing to continue operations. The financial statements had not been previously audited, but audited statements are a condition of the new financing. The new financing agreement also contains a number of requirements based on financial statement balances and ratios. Students must apply professional judgment to determine the appropriate treatment of various accounting issues and the implications for the financial statement balances and ratios.



Chapter 11

Current Liabilities and Contingencies



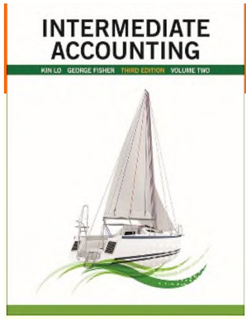
LEARNING OBJECTIVES

L.O. 11-1. Describe the nature of liabilities and differentiate between financial and non-financial liabilities.

L.O. 11-2. Describe the nature of current liabilities and account for common current liabilities including provisions.

L.O. 11-3. Describe the nature of contingent assets and liabilities and account for these items.

L.O. 11-4. Describe the nature of commitments and guarantees and apply accrual accounting to them.



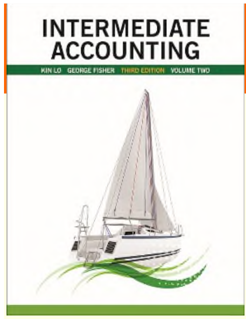
CPA competencies addressed in this chapter

1.1.2 Evaluates the appropriateness of the basis of financial accounting (Level B)

1.1.4 Explains implications of current trends and emerging issues in financial reporting

  a. emerging trends in accounting standards and recent updates

1.2.1 Develops or evaluates appropriate accounting policies and procedures (Level B)



CPA Competencies addressed in this chapter (Continued)

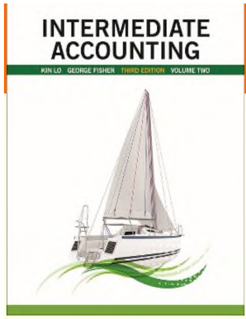
1.2.2 Evaluates treatment for routine transactions (Level A)

- g. Provisions, contingencies, and current liabilities
- k. Financial instruments
- p. Foreign currency transactions

1.3.1 Prepares financial statements (Level A)

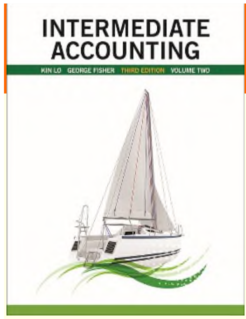
1.3.2 Prepares routine financial statement note disclosure (Level B)

1.4.1 Analyzes complex financial statement note disclosure (Level C)



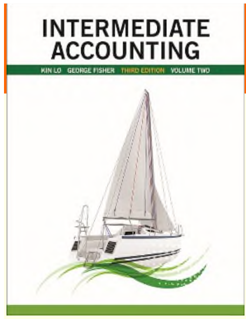
A. INTRODUCTION

- Liabilities are obligations to provide cash /other assets or services to other parties
- Determining the amount to be paid to settle an obligation has its challenges
- Many factors can affect the value of the indebtedness
- Creditors, investors, suppliers, others interested in the amount of liabilities reported



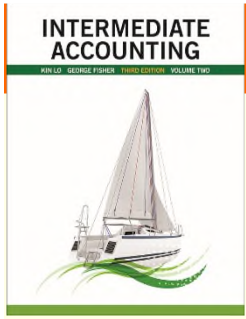
B. DEFINITION, CLASSIFICATION, AND MEASUREMENT OF LIABILITIES (L.O. 11-1)

- Financial statements convey information between preparers and users
- IFRS defines key terms used in preparing financial statements
- Defining key terms enhances the quality of what is being communicated
- Essential to understand key liabilities term



1. Liabilities defined

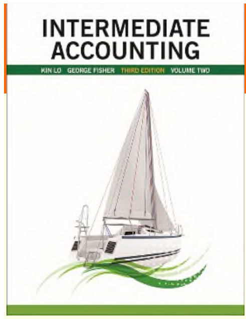
- A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.



2. Recognition

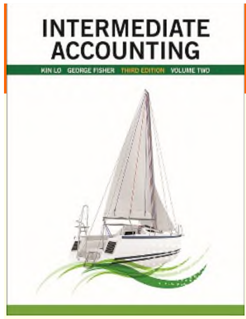
To be included in financial statements:

- Precise amount of obligation not required
- A reliable estimate is required and should normally be available
- Liabilities that are uncertain in amount and/or timing are provisions (e.g. warranty costs)



3. Financial and non-financial liabilities

- Financial liability - a contractual obligation to deliver cash or other financial assets to another party
- Non-financial liability – meets liability criteria but is not contractual.
  - Typically settled through the delivery of goods or provision of services (unearned revenues, warranty liabilities)
- Liabilities established by legislation (such as income taxes payable) are non-financial liabilities - not contractual in nature



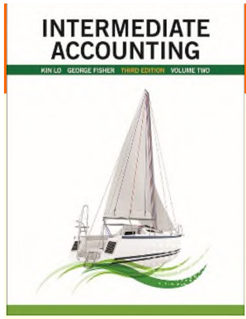
Financial and non-financial liabilities (continued)

Financial liabilities

- Initially measured at fair value
- Subsequently measured at amortized cost
- If held for trading, such as derivatives, then measured at fair value

Non-financial liabilities

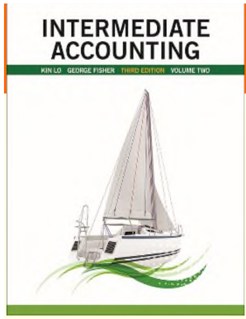
- measured using best estimate at balance sheet date



Financial and non-financial liabilities (Continued)

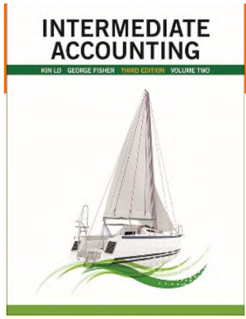
Why distinguish between financial and non-financial liabilities?

Some financial liabilities measured at fair value vs. amortized cost



4. Current versus non-current liabilities

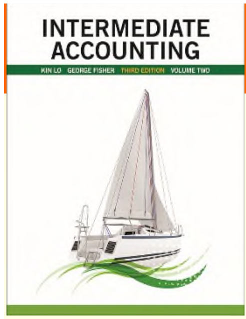
- Current – expected to be settled within one year of the balance sheet date or normal operating cycle
- Held-for-trading (if any) is presented as current
- Present current and non-current separately



5. Measurement

Measurement normally based on nature of obligation

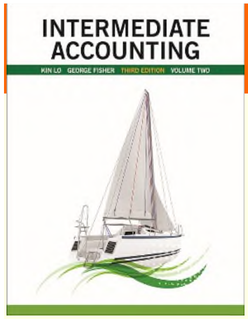
- Held for trading – initially and subsequently measure at fair value
- Other Financial – initially at fair value less transaction costs
  – subsequent to acquisition at amortized cost
- Non-financial – depends on nature; may be best estimate or based on amount initially received



Check Point CP 11-2

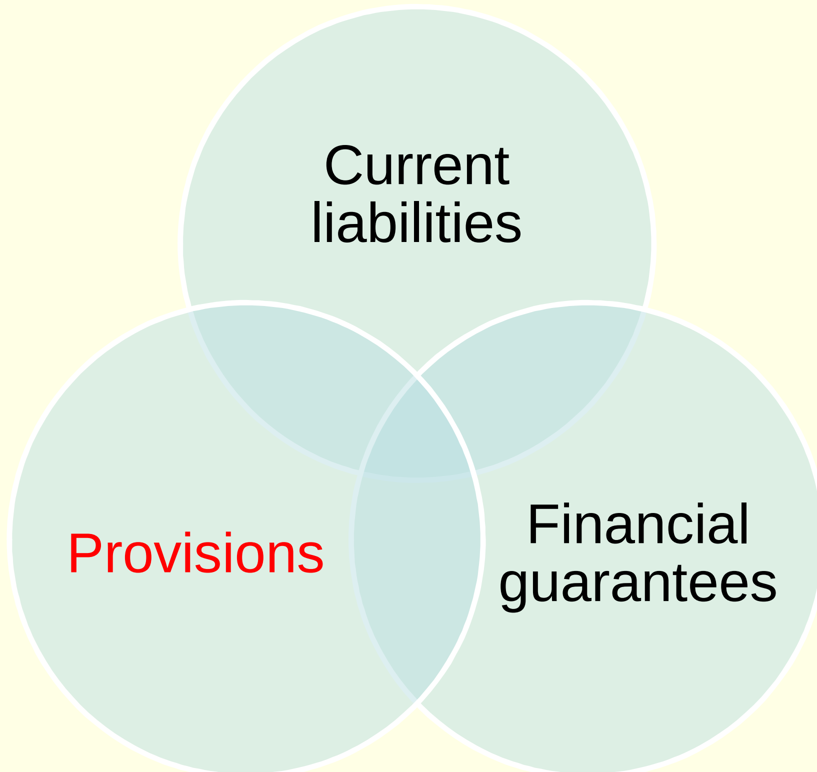
- What are the three criteria of a liability

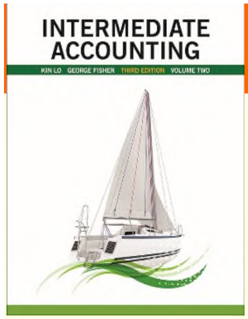
- Also see Problem 11-5



C. CURRENT LIABILITIES (L.O. 11-2)

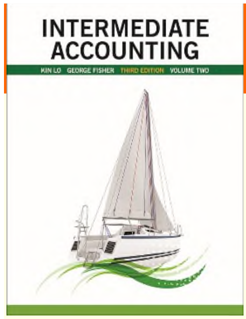
Rest of chapter reviews three broad firm obligations. Common current liabilities are first discussed





1. Trade Payables (Accounts Payable)

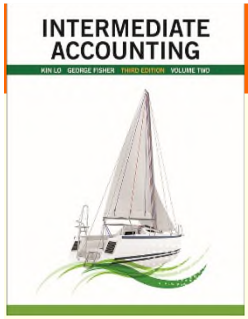
- Normally for goods and services received/used
- Accruals included for invoices "in transit"
- Part of normal course of business
- Not supported by a written promise to pay
- Reported in one total
- Amount known with high degree of certainty
- Consider Cut-off and Gross vs. Net methods



Gross vs. Net Method of Recording Trade Payables

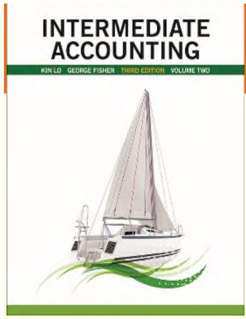
Exhibit 11-1 Supporting journal entries for the gross and net methods for a $100,000 trade payable with terms of 2/10, net 30

	Gross Method		Net Method	
Purchase date				
Dr. Inventory	100,000		98,000	
Cr. Trade payables		100,000		98,000
If discount taken				
Dr. Trade payables	100,000		98,000	
Cr. Cash		98,000		98,000
Cr. Inventory		2,000		
If discount not taken				
Dr. Trade payables	100,000		98,000	
Dr. Purchase discounts lost (an expense)			2,000	
Cr. Cash		100,000		100,000



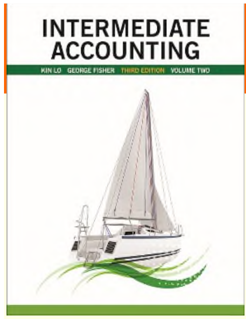
CHECKPOINT: CP 11-3

From a theoretical perspective, should the gross method or net method be use to account for trade payables?



2: Common Non-trade Payables

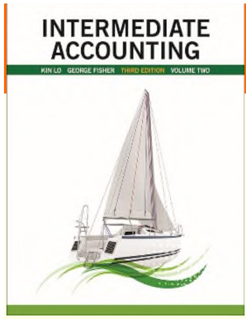
- Do not arise from ordering goods / services
- Aggregation and disclosure vary among firms
- Common ones include:
  - Sales taxes payable
  - Income taxes payable
  - Dividends payable
  - Royalty fees payable



a: Sales Taxes Payable

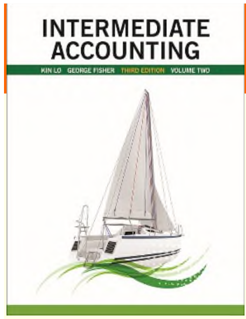
- Total sales taxes depends on province
- Federal Goods and Services Tax (GST)
- Provincial sales tax (PST)
- Or a combination, Harmonized Sales Tax (HST)

- See Exhibit 11-2 for rates at January 1, 2012



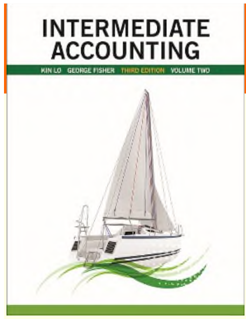
Sales Taxes Payable (continued)

- PST on internal use purchases generally not recoverable
- GST/PST/HST Payable
  - Collected on eligible sales
- GST/PST/HST Recoverable
  - Paid on eligible purchases
- Remit net amounts to appropriate authorities
- See Exhibits 11-4 and 11-5



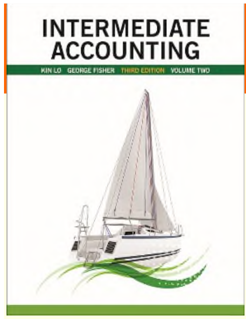
b: Income Taxes Payable

- Taxes on taxable income in chapter 16
- Amount owing is normally a current liability
- Withholdings from employees of federal and provincial income taxes also reported as current liabilities



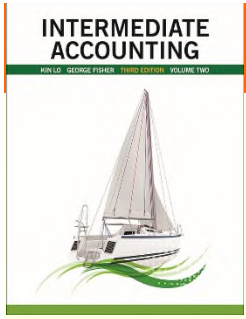
c: Dividends Payable

- Cash Dividends
  - Become a liability when declared
  - Classified as current liability
- Stock Dividends
  - Not a liability even when declared
  - No future outflows of economic resources involved
  - Recorded through retained earnings and other equity account(s)
- Dividends in Arrears on Preferred Shares
  - Undeclared cumulative preferred dividends not recognized as a liability. No declaration, no liability.
  - Require note disclosure



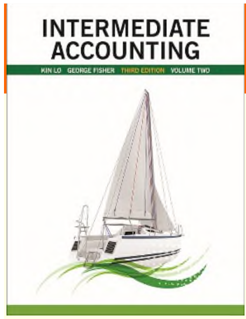
d: Royalty Fees Payable

- Most franchise agreements require franchisees to pay royalties to franchisors (such as Tim Horton's) based on sales
- Oil and gas companies pay royalties to governments
- Publishing companies pay royalties to authors
- Unpaid royalties are current liabilities



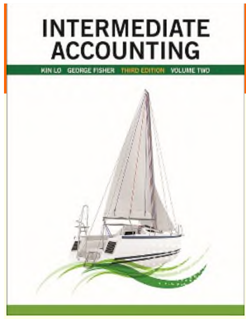
CHECKPOINT: CP 11-4

Can a company report its HST receivable and payable as a net amount on the balance sheet? Why or why not?



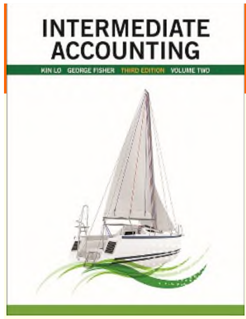
3. Notes payable

- Supported with a written promise to pay
- Used in credits over extended periods
- Can be current, non-current, or combination
- Can be interest bearing – measured at fair value (Exhibits 11-6; 11-8d)
- Can be non-interest bearing – normally estimated using valuation techniques, such as discounted cash flows



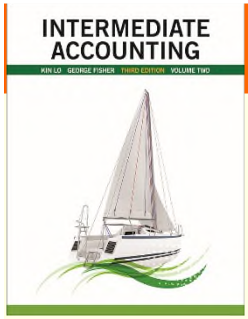
CHECKPOINT: CP 11-5

Why are short-term trade payables normally valued at the original invoice amount rather than the fair value?



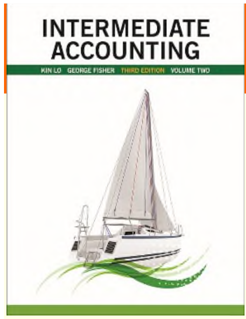
4. Credit (Loan) Facilities

- Permits borrowing on an ongoing basis
  - Referred to as a line of credit
- Limit and other terms and conditions of credit agreement is documented
- Most credit facilities are due on demand
- “Due on demand” makes it a current liability
- Disclosure required in the notes



5. Warranties

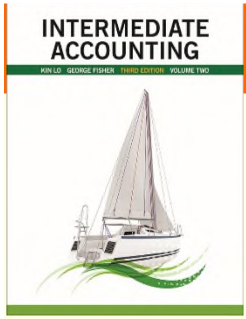
- Warranty - a guarantee that products will be free from defects for a specified period, agreeing to fix or replace them if they are faulty
- Two types
  - Manufacturers (included in product price)
  - Sold separately (manufacturer or another party)



Warranties (Continued)

Warranty Embedded in Product

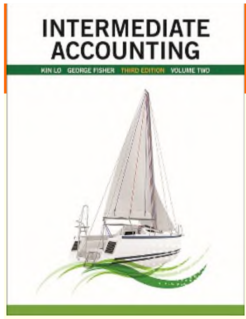
- Results in a provision and an expense (year of sale)
- Measured using expected value techniques
- Subsequent claims charged to the provision
  - Offset to inventory, labour or other expenses to satisfy the claim
- Can extend beyond a year, but all charged in sale year
- Liability may be current or non-current



Warranty Embedded in Sales Price

A: Expense as Incurred and Adjust at year-end	B: Provision at time of sale
At Time of sale:	At Time of sale:
No Entry for warranty expense	Dr. Warranty expense xxx Cr. Provision for Warranty Payable xxx
Actual Warranty Costs Incurred	Actual Warranty Costs Incurred
Dr. Warranty Expense xxx Cr. Cash/Inventory/Payroll xxx	Dr. Provision for Warranty Payable xxx Cr. Cash/Inventory/Payroll xxx
Year-end Adjusting entry (to ensure proper provision for year)	Year-end Adjusting entry
Dr. Warranty Expense xxx Cr. Provision for Warranty Payable xxx	No Entry (unless to cater for new information)

Same expense for year and same liability at year-end under either approach



Warranty Sold Separately

At time of sale:

Dr. Cash	xxx	
Cr. Sales Revenue		xxx
Cr. Unearned Warranty Revenue		xxx

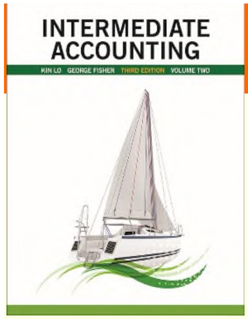
As time passes (Expense incurred)

Dr. Warranty Expense	xxx	
Cr. Cash/Inventory/Payroll		xxx

&

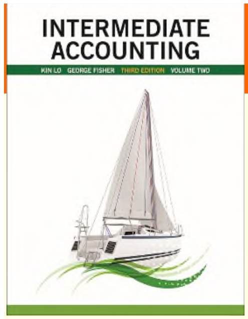
Dr. Unearned Warranty Revenue	xxx	
Cr. Warranty Revenue		xxx

Revenue determined based on expense incurred or time elapsed



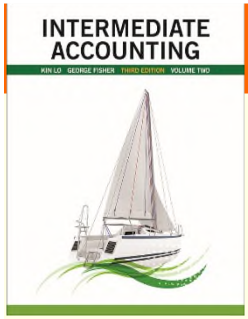
CHECKPOINT **CP:11-6**

What technique is used to estimate the required provision for warranties?



6. Deferred Revenues

- Arise from collection of assets not yet earned
- Also called: Unearned revenue; Deposits
- May arise from customer loyalty programs
- Can have current/noncurrent components
- When "earned" unearned amount becomes revenue



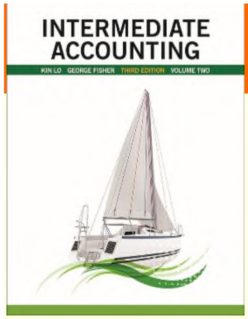
6. Deferred Revenues (continued)

When cash is received:

Dr. Cash	xxx	
Cr. Deferred Revenue		xxx

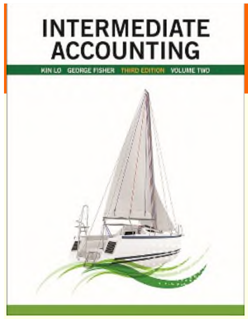
When revenue is earned (service / good provided)

Dr. Deferred Revenue	xxx	
Cr. Revenue		xxx



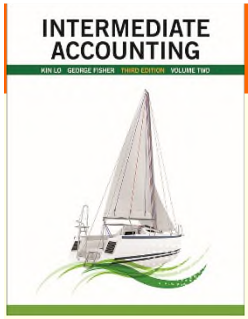
7. Customer Incentives

- Customer incentives: promote product or brand loyalty and repeated patronage of goods and services designed to increase sales
- Include:
  - Customer loyalty programs
  - Discount vouchers (coupons)
  - Rebates



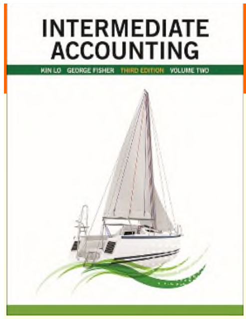
a. Customer Loyalty Programs

- Examples:
  1. Point awards redeemed for merchandise
  2. Frequent flyers miles exchanged for future flights or other products



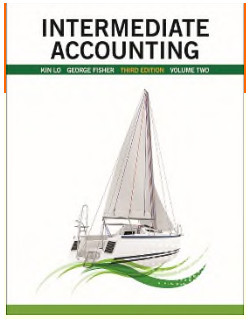
Customer Loyalty Programs (Continued)

- Loyalty programs share two essential commonalities:
  1. Grant material rights for future benefits for free or at a discount, and
  2. Underline transaction involves multiple deliveries, including in the future
     1. Fulfilling the terms of the current sales (e.g., flight ticket)
     2. Meeting the loyalty program commitment (e.g., free miles converted into a flight ticket/product)



Customer Loyalty Programs (Continued)

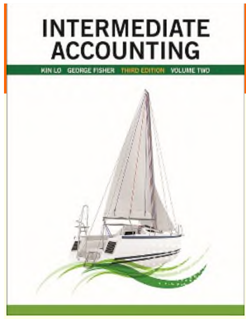
- Measurement of the award part of the transaction is complex - Governed by IFRS 15, Revenue from Contracts with Customers
- Factors to consider in determining the liability amount
  1. The proportion of the transaction price allocated to the future obligation
  2. If stand-alone price is not directly observable, an estimate must be made. Consider factors such as the rate of redemption



Customer Loyalty Programs (Continued)

Three primary methods of offering awards:

1. Rewards supplied by the company itself
2. Rewards supplied by a third party
3. Rewards by choice – either provided by the company itself or by a third party



Customer Loyalty Programs (continued)

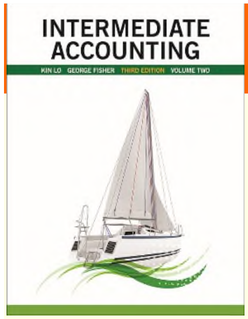
- **Third party awards**: Recognize expense based on cost to purchase awards for the customers
- At time of sale

Dr. Cash /Accounts Receivable	xxx	
Cr. Sales Revenue		xxx

&

Dr. Loyalty Awards Expense	xxx	
Cr. Liability for Loyalty Awards		xxx

– Reduce liability as awards are used up



Customer Loyalty Programs (continued)

Awards by Entity: two distinct components

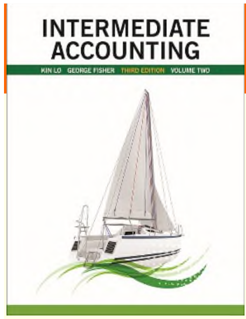
- revenue recognized when each component is earned
- the reward segment is earned when the customer redeems the award

At time of sale:

Dr. Cash/Accounts Receivable	xxx	
Cr. Regular Revenue		xxx
Cr Unearned Revenue, Awards		xxx

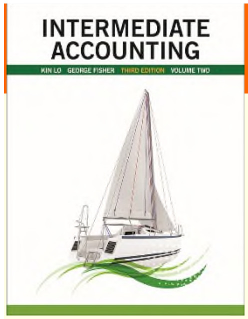
When awards are redeemed

Dr. Unearned Awards Revenue	xxx	
Cr. Awards Revenue		xxx



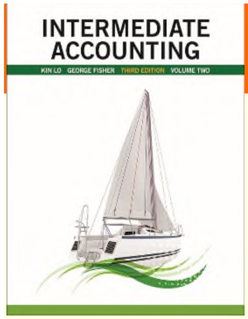
b. Discount Vouchers (Coupons)

- Entitles consumer to a discounted price on future purchases
- Accounting treatment is similar to that when awards for loyalty programs are supplied by the entity



c. Rebates

- A proof of purchase sent to manufacturer who sends customer agreed-upon amount
- The sales revenue recognized must be adjusted downward to reflect the expected rate of rebate redemption against a liability

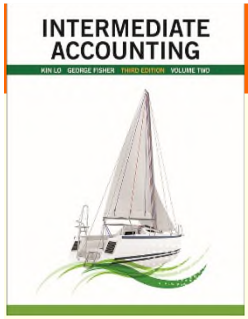


Premiums, Coupons and Rebates (continued)

Accounting for coupons and rebates similar to accounting for warranties embedded in the product

(Subsection C-5 above)

Change in management's estimate for redemption is accounted for prospectively

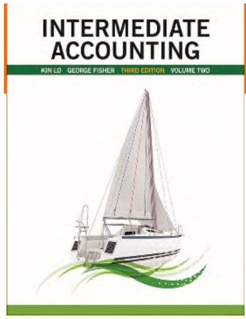


CHECKPOINT: CP 11-8

What are the three common ways of offering loyalty awards?

8. Other Current Liabilities

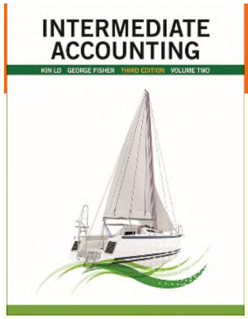
- Those requiring special mention discussed in the following slides



Other Current Liabilities (continued)

a: Obligations denominated in another currency

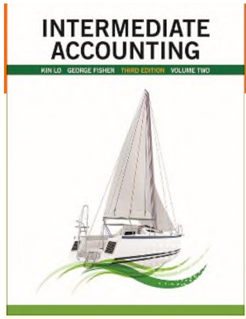
- Translate into functional currency with exchange rate on transaction date
- Translate obligation at period-end with exchange rate at period's end.
- Recognize gain or loss on translation in income



Other Current Liabilities (continued)

b: Maturing debt to be refinanced

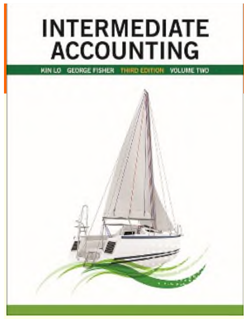
- If refinancing agreement not in place by balance sheet date – classify as a current liability
- Disclose refinancing arrangements made subsequent to balance sheet date but before issue date



Other Current Liabilities (continued)

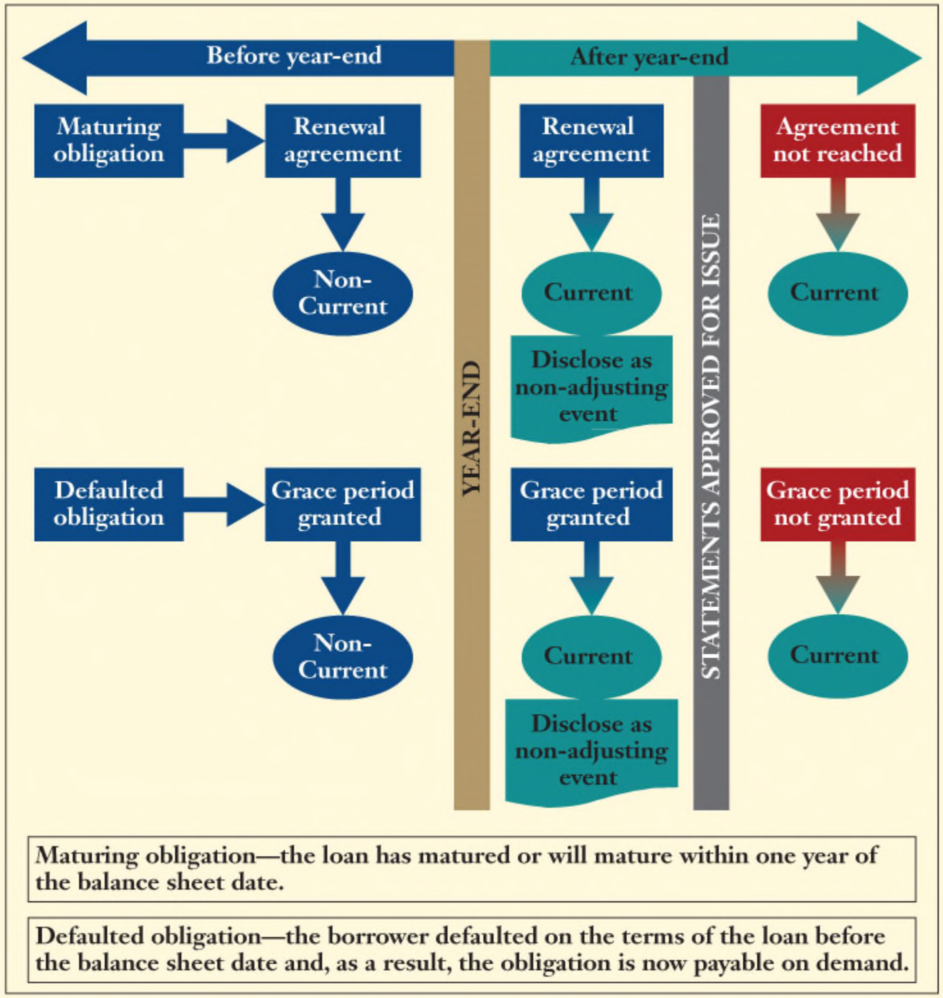
c: Non-current debt in default

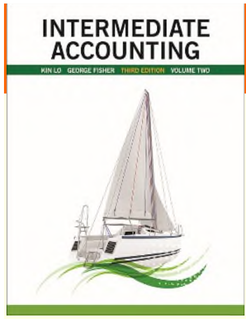
- Treat as a current liability
- Classify as non-current if, before period-end, lender provides a grace period longer than 12 months from balance sheet date
- If lender extends terms before statements are issued present as current and disclose grace period.



Other Current Liabilities (continued)

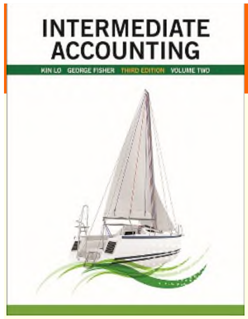
Exhibit 11-16 Classification of maturing debt and loans in default





CHECKPOINT: CP-9

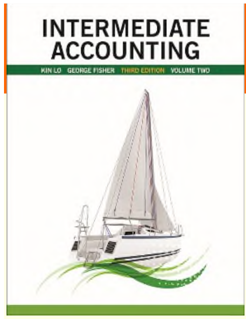
How are liabilities denominated in foreign currencies accounted for at the transaction date? At period end(s)?



D. CONTINGENCIES (L.O. 11-3)

Contingency - an existing condition that depends on the outcome of one or more future events

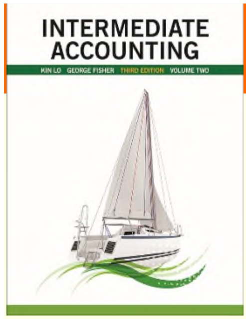
- Probability of future outcomes crucial to accounting treatment of contingencies
- Three ranges of probabilities
  - Probable
  - Remote
  - Possible



The Probability Continuum

Exhibit 11-17 The probability continuum

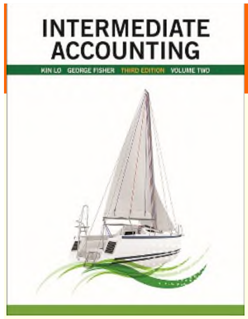
Remote		Possible	Probable	
0%	5–10%	50%	>50%	100%



Contingencies (continued)

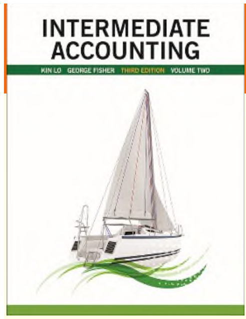
- Issue: are *contingent* amounts measurable with sufficient reliability?

- IAS 37 paragraphs 25–26 assert that only in extremely rare cases will the entity be unable to determine a range of possible outcomes used to estimate the extent of the obligation



1. Contingencies Involving Potential Outflows

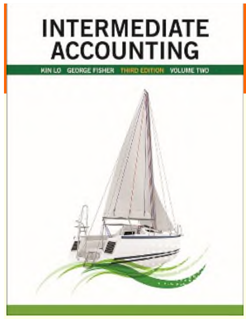
- **Results in one of three outcomes:**
  a. Recognition of a *provision*
  b. Disclose as a contingent liability in notes to the financial statements
  c. No action required



Contingencies Involving Potential Outflows (continued)

Exhibit 11-18 Accounting for contingent outflows

		Likelihood		
		Remote	**Possible**	**Probable**
Measurability	Obligation can be reliably measured	No action required 3	Disclose a contingent liability in the notes to the financial statements 2	Recognize a provision for the obligation 1
	Obligation cannot be reliably measured (rare)	No action required 6	Disclose a contingent liability in the notes to the financial statements 5	Disclose a contingent liability in the notes to the financial statements 4



a. Recognition of a Provision

- Provision required when outflow is

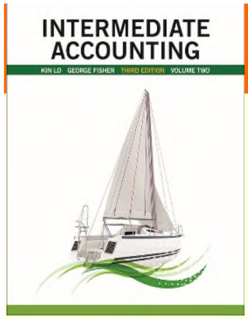
  i. probable , and

  ii. measurable

  in that case, expense and liability are accrued

  (See Exhibit 11-19a)

- Range of outcomes? Use expected value techniques (weighted average)



b. Disclosure as a Potential Liability

When:

i. contingent outflow is not probable, or

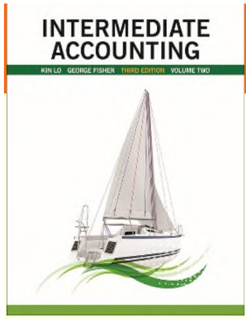
ii. future outflows cannot be measured reliably,

then;

Disclose a contingent liability in the notes.

(Cells 2, 5, and 4 of Exhibit. 11-18)

(Also see Exhibit 11-19b)



c. No Action Required

When:

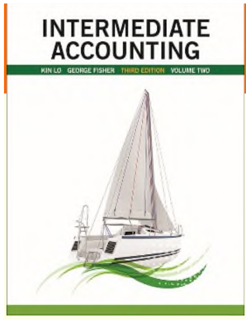
i. Probability of contingent outflow is remote,

then;

neither recognition nor disclosure warranted.

(Cells 3, 6 of Exhibit. 11-18)

(Also see Exhibit 11-19a)



Illustrations of accounting for contingencies

Scenario 1

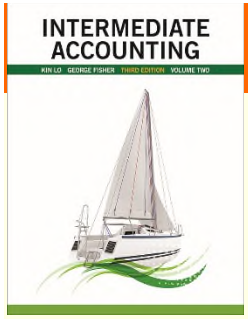
Exhibit 11-19a Illustrations of accounting for contingencies—Scenario 1

Frieda Hengemolen slips on a wet floor in Fred Geotechnical's office, falls, and breaks her arm. Frieda sues Fred Geotechnical for $2 million in damages, alleging negligence. Fred's law firm advises that the company is indeed liable and that the courts will likely award damages to the litigant. The lawyers suggest that it is very unlikely the courts will award the full $2 million sought as the normal settlement for this type of injury is $100,000 to $200,000. In their opinion, all payouts within this range are equally likely.

Required accounting: In this instance Fred Geotechnical provides for a $150,000 liability (the midpoint of the range) as the payout is probable and can be reasonably estimated.

Dr. Lawsuit settlement expense	150,000	
Cr. Provision for liability settlement costs		150,000

[($100,000 + $200,000) ÷ 2 = $150,000]



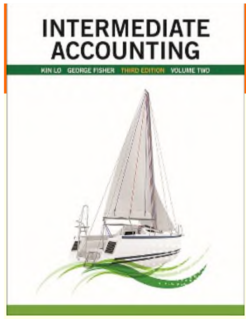
Illustrations of accounting for contingencies

Scenario 2

Exhibit 11-19b Scenario 2

Zulu Geothermal sues Roxanne Geothermal for patent infringement, seeking $10 million in damages. The matter is a highly technical one that hinges upon the judge's understanding of the testimony of a number of scientists. Roxanne's lawyers are unsure as to the outcome but estimate the plaintiff's probability of success to be about 25%.

Required accounting: In these circumstances, Roxanne Geothermal discloses the details of the contingent liability in the notes to its financial statements but does not make provision for a liability as payout is estimated to be possible, but not probable.



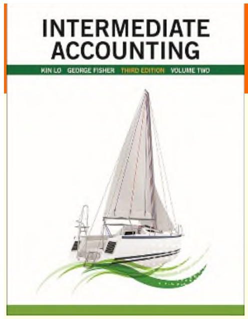
Illustrations of accounting for contingencies

Scenario 3

Exhibit 11-19c Scenario 3

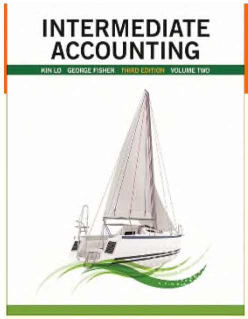
Angel Smith, who lives close to the ZMEX radio station, sues for $100 million in damages. Smith alleges that the radio waves broadcast by ZMEX caused his wife's brain cancer and ultimately led to her death. ZMEX's law firm advises the company that this is a nuisance lawsuit that is unlikely to succeed. They are confident that the courts will dismiss the case as being without merit.

Required accounting: Given these circumstances, ZMEX does not provide for a liability nor does it disclose the lawsuit in the notes to its financial statements. No action is required as the litigant's probability of success is remote.



2. Contingencies Involving Potential Inflows

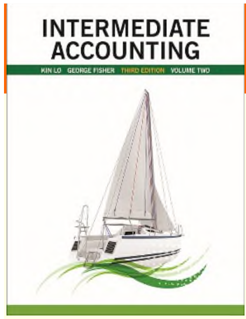
- Stronger evidence required to recognize contingent inflows (prudence, conservatism). Results in one of three outcomes:
  - a. Recognition as an asset ($\geq$ 95%)
  - b. Disclose as a contingent asset
  - c. No action required



Contingencies Involving Potential Inflows (continued)

a. Recognition as an asset

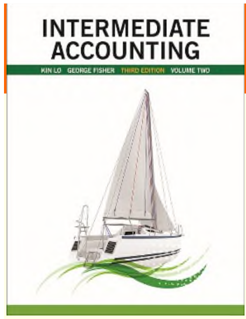
- Only permitted if inflow is virtually certain (in practice $\geq$ 95% probable.)
- Contrasts recognition of contingent outflow as a provision when probable ($\geq$ 50%)



b. Disclosure as a Contingent Asset

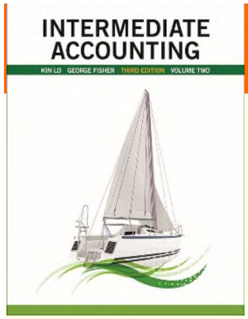
When a contingent inflow is probable (> 50%), IFRS recommends disclosing a contingent asset, defined as:

- a possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more future events



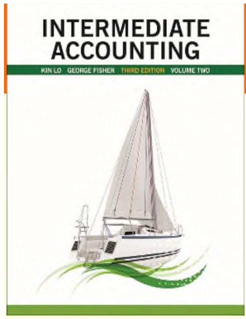
c. No Action Required

When a contingent inflow is not probable (< 50%), neither recognition nor disclosure is warranted.



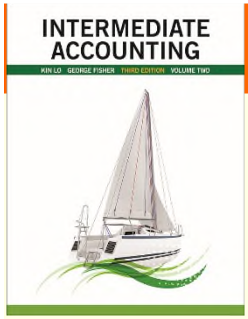
CHECKPOINT: **CP- 10**

In the context of accounting for contingencies under IFRS, what do the terms ***probable***, ***possible***, and ***remote*** mean?



CHECKPOINT: **CP-11**

When is a provision recognised for a contingency involving potential outflows?



3. Treatment of Contingencies Under ASPE

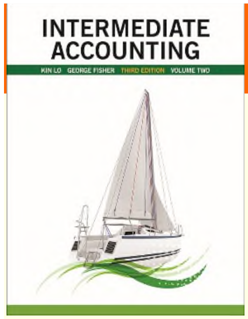
- Inflows and outflows treated differently (as in IFRS)
- ASPE uses a different range of probabilities
- Uses "likely" (70%) vs. IFRS' "probable" (>50%)
- Income statement focused: (contingent gains/losses) vs. IFRS' contingent assets/liabilities (balance sheet).
- When amounts in a range are equally possible, ASPE recognizes lower amount and discloses maximum; IFRS uses expected value in the range.

E. COMMITMENTS AND GUARANTEES (L.O. 11-4)

1. Commitments

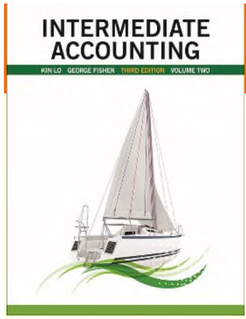
- Require companies to do things in the future
- Users interested in these future obligations
- Required to disclosure certain commitments in notes (e.g. commitment to buy property plant and equipment)
- Other commitments recognized on the balance sheet
  - Onerous contracts

See Exhibit 11-22



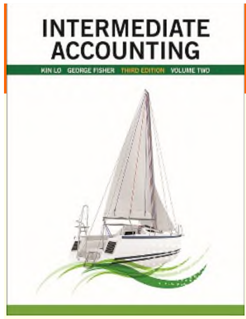
2. Guarantees

- Must be recognized at their fair value;
- Details must be disclosed



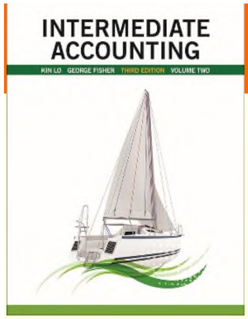
F. PRESENTATION AND DISCLOSURE

- Disclosure requirements are extensive
- Disclosure requirements include the following:
  - IAS 1 Presentation of Financial Statements
  - IAS 32 Financial Instruments Presentation
  - IAS 37 Provisions, Contingent Assets/Liabilities
  - IFRS 7 Financial Instruments: Disclosures
  - IFRS 9 Financial Instruments



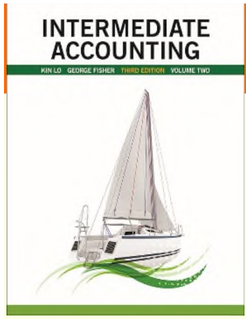
G. SUBSTANTIVE DIFFERENCES BETWEEN RELEVANT IFRS AND ASPE

ISSUE	IFRS	ASPE
Contingencies—focus on balance sheet or income statement	Standard refers to contingent assets or liabilities.	Classified as contingent gains or losses.
Contingencies—terminology	Contingent assets and contingent liabilities refer to contingencies that are not recognized as provisions.	Contingent gains and contingent losses refer to the potential for gains or losses that depend on future events, irrespective of accounting treatment.
Contingencies—range of estimates for recognition of contingent loss	Use the amount of the most probable outcome in the range. If no estimate in the range is more likely than another, recognize the midpoint of the range as a provision.	Use the amount for the most probable outcome in the range. If no estimate in the range is more likely than another, recognize the minimum value in the range as a contingent loss and disclose remainder.
Customer loyalty programs	IFRS 15 requires sales transactions to be segregated into components: earned revenue arising from the sale of goods or service, and unearned revenue for the obligation to provide an award credit at a later date.	ASPE does not specifically address accounting for customer loyalty programs.
Disclosures for liabilities	Disclosure requirements are complex. Relevant standards that must be observed include IAS 37 and IFRS 7.	Disclosure requirements are much less demanding because users have the ability to obtain additional details from the reporting enterprise.
Onerous contracts	IAS 37 requires companies to provide for the cost of onerous contracts.	ASPE does not specifically address accounting for onerous contracts.



H. STANDARDS IN TRANSITION

- IASB in the midst of replacing IAS 39, Financial Instruments: Recognition and Measurement with IFRS 9, Financial Instruments. Planned adoption date is January 1, 2015. Deals with:
  - classification and measurement of financial assets and liabilities
  - Impairment methodology
  - Hedge Accounting



I. SUMMARY

L.O. 11-1. Describe the nature of liabilities and differentiate between financial and non-financial liabilities.

L.O. 11-2. Describe the nature of current liabilities and account for common current liabilities including provisions.

L.O. 11-3. Describe the nature of contingent assets and liabilities and account for these items.

L.O. 11-4. Describe the nature of commitments and guarantees and apply accrual accounting for them.