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Chapter 13

In a Set of Financial Statements, What Information Is Conveyed about Current and Contingent Liabilities?

Video Clip

[\(click to see video\)](#)

In this video, Professor Joe Hoyle introduces the essential points covered in [Chapter 13 "In a Set of Financial Statements, What Information Is Conveyed about Current and Contingent Liabilities?"](#).

13.1 The Basic Reporting of Liabilities

LEARNING OBJECTIVES

At the end of this section students should be able to meet the following objectives:

1. Define a liability by listing its essential characteristics.
2. Differentiate a current liability from a noncurrent liability.
3. Explain the significance that current liabilities have for investors and creditors who are studying the financial health and future prospects of an organization.
4. Compute the current ratio.
5. Identify the appropriate timing for the recognition of a liability.

Current and Noncurrent Liabilities

*Question: The June 30, 2011, consolidated balance sheet for The Procter & Gamble Company reports total **liabilities**¹ of over \$70 billion, including current liabilities of approximately \$27 billion. In contrast, the business held only \$2.8 billion in cash and cash equivalents.*

*For reporting purposes, Procter & Gamble divided its **current liabilities**² into several specific categories:*

- Accounts payable (\$8.0 billion)
- Accrued and other liabilities (\$9.3 billion)
- Debt due within one year (\$10.0 billion)

When creating a balance sheet, what is reported as a liability? Why are some of these liabilities shown as current whereas others are not? How does an accountant draw a distinction between liabilities that are labeled as current and those that are reported as noncurrent?

1. Probable future sacrifices of economic benefits arising from present obligations; the debts of an organization.
2. Debts that will be satisfied within one year from the date of a balance sheet.

Answer: A liability is an obligation owed to a party outside the reporting organization—a debt that can be stated in monetary terms. Liabilities normally require the payment of cash but might at times be settled by the conveyance of

other assets or the delivery of services. Some reported liabilities are for definite amounts, although a significant number are no more than estimations.

The distinction between current and **noncurrent liabilities**³ is a function of time. A debt that is expected to be satisfied within one year from the balance sheet date is normally classified as a current liability. In upper-level accounting courses, the definition of a current liability is refined a bit. It refers to any liability that will require the use of a current asset or the creation of another current liability. However, the one-year standard presented in this textbook is sufficient in a vast majority of cases. Amounts owed for rent, insurance, utilities, inventory purchases, and the like usually fall into this category. If payment will not be made until after that one-year interval, the liability is reported as noncurrent. Bonds and notes payable are common examples of noncurrent debts as are liabilities for employee pensions, long-term leases, and deferred income taxes. Current liabilities are listed before noncurrent liabilities on a balance sheet.

The Importance of Information about Liabilities

Question: Figure 13.1 "Liability Section of Balance Sheet, Johnson & Johnson as of January 2, 2011" is the liability section of the balance sheet reported by Johnson & Johnson as of January 2, 2011. Note that additional information about many of these liabilities is available in the notes to the company's financial statements.

3. Debts that will not be satisfied within one year from the date of a balance sheet.

Figure 13.1 *Liability Section of Balance Sheet, Johnson & Johnson as of January 2, 2011*

All figures in millions	
Current liabilities	
Loans and notes payable (Note 7)	\$ 7,617
Accounts payable	5,623
Accrued liabilities	4,100
Accrued rebates, returns and promotions	2,512
Accrued compensation and employee related obligations	2,642
Accrued taxes on income	<u>578</u>
Total current liabilities	23,072
Long-term debt (Note 7)	9,156
Deferred taxes on income (Note 8)	1,447
Employee related obligations (Notes 9 and 10)	6,087
Other liabilities	<u>6,567</u>
Total liabilities	46,329

Investors and creditors (and other interested parties) who analyze an organization such as Johnson & Johnson usually spend considerable time studying the data that is provided about liabilities, often focusing on current liabilities. Why is information about liabilities, especially the size and composition of current liabilities, considered so important when assessing the financial position and economic health of a business?

Answer: Liabilities represent claims to a company's assets. Debts must be paid as they come due or the entity risks serious consequences. Missed payments might damage a company's ability to obtain additional credit in the future. Unfortunately, even bankruptcy can quickly become a possibility if obligations are not met.

To stay viable, organizations have to manage their liabilities carefully. They must be able to generate sufficient cash on an ongoing basis to meet all required payments. Virtually no other goal can be more important, both to company officials and external decision makers.

In general, the larger a liability total is in comparison to the reported amount of assets, the riskier the financial position. The future is always cloudy for a business when the size of its debts begins to approach the total of its assets. The amount reported as current liabilities is especially significant because those debts must be satisfied in the near future. Cash has to be available quickly, often within weeks or months.

Not surprisingly, decision makers become concerned when the reported total for current liabilities is high in comparison with current assets. The essential question is obvious: will the organization be able to meet those obligations as they come due? In a newspaper account about the financial difficulties of **Advanced Cell Technology**, the following warning was issued: “It reported \$17 million in current liabilities, but only \$1 million in cash and other current assets, an indication it could be forced to file for bankruptcy protection.” Todd Wallack, “Fame-courting biotech running short of cash,” *The Boston Globe*, July 17, 2008, A-1.

As mentioned in an earlier chapter, one vital sign monitored by decision makers in judging the present level of risk posed by a company’s liability requirements is the **current ratio**⁴: current assets divided by current liabilities. The current ratio is a simple benchmark that can be easily computed using available balance sheet information. Although many theories exist as to an appropriate standard, any current ratio below 1.00 to 1.00 signals that the company’s current liabilities exceed its current assets. Figure 13.2 "Sample of Recent Current Ratios as of January 29, 2011" presents recent current ratios for three well-known companies: **Target**, **Dillard’s**, and **Aeropostale**.

Figure 13.2 Sample of Recent Current Ratios as of January 29, 2011

Target	1.71 to 1.00 (at 12/31/10)
Dillard's	2.05 to 1.00 (at 1/29/11)
Aeropostale	2.17 to 1.00 (at 1/31/11)

4. Formula measuring an organization’s liquidity (the ability to pay debts as they come due); calculated by dividing current assets by current liabilities.

TEST YOURSELF

Question:

The Petersen Company currently holds \$500,000 in current assets and \$200,000 in current liabilities. The company borrows \$60,000 cash. However, a question arises as to whether this debt is a current or noncurrent liability. Which of the following statements is true?

- a. If the liability is noncurrent, the transaction has no impact on the current ratio.
- b. If the liability is noncurrent, the transaction causes the current ratio to increase.
- c. If the liability is current, the transaction has no impact on the current ratio.
- d. If the liability is current, the transaction causes the current ratio to increase.

Answer:

The correct answer is choice b: If the liability is noncurrent, the transaction causes the current ratio to increase.

Explanation:

If the liability incurred here is noncurrent, the transaction causes current assets to go up by \$60,000, but there is no change in current liabilities. Thus, the current ratio (current assets divided by current liabilities) will be higher. If the liability is current, the transaction causes both the current asset total and the current liability total to increase by \$60,000. The current ratio is no longer 2.50 to 1.00 ($\$500,000/\$200,000$) but will fall to 2.15 to 1.00 ($\$560,000/\$260,000$).

Characteristics of a Liability

Question: In the real world of business, organizations are not inclined to report more liabilities than necessary because of potential damage to the image being portrayed. The inclusion of debts usually makes a company look riskier to creditors and investors. Thus, the danger that officials will report an excessive amount of liabilities seems slight. Balance sheets look better to decision makers if fewer obligations are present to drain off financial resources. Consequently, where possible, officials probably have a tendency to limit the debts

that are reported. At what point does an entity have to recognize a liability? How does U.S. GAAP ensure that all liabilities are appropriately included on a balance sheet?

Answer: FASB *Statement of Financial Accounting Concepts No. 6* defines many of the elements found in a set of financial statements. According to this guideline, a liability should be recognized when all of the following characteristics exist:

1. There is a probable future sacrifice
2. This sacrifice involves the reporting entity's assets or services.
3. The sacrifice arises from a present obligation that is the result of a past transaction or event.

To understand the reporting of liabilities, several aspects of these characteristics are especially important to note. First, the obligation does not have to be absolute before recognition is required. A future sacrifice only has to be "probable." This standard leaves open a degree of uncertainty. As might be expected, determination as to whether a potential payment is probable or not can be a point of close scrutiny when independent CPAs audit a set of financial statements. The line between "probable" and "not quite probable" is hardly an easily defined benchmark.

Second, for reporting to be required, a debt must result from a past transaction or event.

- An employee works for a company and is owed a salary. The work previously performed is the past event that creates the obligation.
- A vendor delivers merchandise to a business. Receipt of these purchased goods is the past event that creates the obligation.

Third, the past transaction or event must create a present obligation. In other words, an actual debt must exist and not just a potential debt. Ordering a piece of equipment is a past event but, in most cases, no liability has yet been incurred. In contrast, the delivery of this equipment probably does obligate the buyer and, thus, necessitates the reporting of a debt. Often, in deciding whether a liability should be recognized, the accountant must address two key questions: what event actually obligates the company, and when did that event occur?

Determining all of the liabilities to be included on a balance sheet often takes considerable thought and analysis. Accountants for the reporting company produce

a list of debts that meet the characteristics listed above. The independent auditor then spends considerable time and energy searching for any other obligations that might have been omitted, either accidentally or on purpose.

KEY TAKEAWAY

Because of the negative impact on the information being reported, companies prefer not to include liabilities. An excessive debt load, especially in regard to current liabilities, makes a company's financial affairs appear riskier. Current liabilities typically are those debts that must be satisfied within one year from the balance sheet date. Because a company must be able to meet these debts as they come due, analysts pay close attention to this total. For the same reason, the current ratio (current assets divided by current liabilities) is also watched closely as a sign of financial strength. To prevent misleading financial statements, U.S. GAAP has established guidelines to help ensure the proper inclusion of liabilities. When specified characteristics are met, a liability must be reported. Thus, a liability must be reported to reflect a probable future sacrifice of an entity's assets or services arising from a present obligation that is the result of a past transaction or event.

13.2 Reporting Current Liabilities Such as Gift Cards

LEARNING OBJECTIVES

At the end of this section students should be able to meet the following objectives:

1. Define and record accrued liabilities.
2. Report the sale and redemption of gift cards.
3. Account for gift cards that are not expected to be redeemed.

Recognizing All of a Company's Current Liabilities

Question: Current liabilities often include rent payable, salary payable, insurance payable, and the like. These debts are incurred in connection with day-to-day operations. The amounts are known and payment will be made within a relatively short period of time.

*Liabilities that result from physical events such as the purchase of inventory or supplies are often reported under the generic title "accounts payable." Other current debts (interest payable or rent payable, for example) are sometimes grouped together as **accrued liabilities**⁵ because they grow gradually in size over time rather than through a specific transaction. How does an organization determine the amount of current liabilities to be reported on its balance sheet?*

Answer: As discussed in a previous chapter, the timing for the recognition of a purchase is guided by the FOB point specified by the seller or negotiated by the parties. If marked "FOB shipping point," the liability is reported by the buyer when the goods leave the seller's place of business. "FOB destination" delays recording until the merchandise is received by the buyer. Unless goods are damaged during transit or a dispute arises over payment for transportation charges, the FOB point is only relevant near the end of the fiscal year as the accountant attempts to separate transactions between one period and the next.

5. Liabilities that grow gradually because of the passage of time; common examples include salaries, rent, and interest.

Many other liabilities are not created by a specific event but rather grow gradually day by day. Interest and rent are common examples but salaries, payroll taxes, and utilities also accrue in the same manner. They increase based on the passage of

time. Interest on a loan or the amount due to an employee gets larger on a continual basis until paid. Adjusting entries are required at the end of a period to recognize any accrued liabilities that have been omitted from the general ledger.

To illustrate, assume a large group of employees earns total wages of \$10,000 per day. They work Monday through Friday with payment made on the final day of each week. If the company's fiscal year ends on a Wednesday, an adjustment is necessary so that both the expense on the income statement and the liability on the balance sheet are presented fairly for the three days that passed without payment. The adjustment shown in [Figure 13.3 "Year-End Adjusting Entry to Recognize Debt to Employees for Three Days' Work"](#) is made for \$30,000 (\$10,000 per day for three days) so that the debt incurred for salaries prior to the end of the year is reported. The expense is recognized in this period to match the cost with the revenues that were earned during these three days by the employees.

Figure 13.3 Year-End Adjusting Entry to Recognize Debt to Employees for Three Days' Work

Wages Expense	30,000	
Wages Payable		30,000

As a second example, assume a company borrows \$100,000 from a bank on December 1 with payment to be made in six months. The bank has to earn a profit and charges a 6 percent annual interest rate. By the end of that year, the company owes interest but only for the one month that has passed. As of December 31, interest expense has grown to \$500 ($\$100,000 \text{ principal} \times 6 \text{ percent} \times 1/12 \text{ year}$). This accrued liability is recognized through the adjusting entry shown in [Figure 13.4 "Year-End Adjusting Entry to Recognize Interest for One Month"](#).

Figure 13.4 Year-End Adjusting Entry to Recognize Interest for One Month

Interest Expense	500	
Interest Payable		500

TEST YOURSELF

Question:

An organization rents a warehouse for \$8,000 per week. Cash payments are made to the owner of the building at the end of every six weeks. No payments were made for the last four weeks of Year One but the company accountant forgot to accrue this liability. Which of the following statements is not true concerning the Year One financial statements?

- a. The current ratio is overstated.
- b. Total liabilities are understated.
- c. Net income is understated.
- d. Rent expense is understated.

Answer:

The correct answer is choice c: Net income is understated.

Explanation:

Rent expense and rent payable for these four weeks (\$32,000) have been omitted. Current liabilities (and, hence, total liabilities) are understated because of the debt was never recorded. If current liabilities are too low, the current ratio (current assets/current liabilities) is too high. Rent for this period has not been recorded so the expense on the income statement is understated, which makes the reported net income too high.

Reporting the Sale of Gift Cards as a Liability

*Question: The February 26, 2011, balance sheet for Best Buy Co. Inc. shows several typical current liability accounts such as accounts payable and accrued liabilities. However, a \$474 million figure also appears titled “Unredeemed **Gift Card Liabilities**”⁶.*

*Over the last decade or so, the importance of gift cards has escalated dramatically as a source of revenue for many businesses. By purchasing such cards, customers obtain the right to a specified amount of goods or services. From Starbucks to McDonald’s to Amazon.com, these cards are sold to serve as gifts or merely as a convenient method for handling future payments. How does a company such as **Best Buy** account for the thousands of gift cards that it sells each year?*

6. An obligation arising when a business accepts cash and issues a card that can be redeemed in the future for a specified amount of assets or services.

Answer: As stated previously, a liability represents a probable future sacrifice of an asset or service. By selling a gift card, a company has created an obligation to the customer that must be reported. Businesses such as **Best Buy** or **Barnes & Noble** accept cash but then have to be willing to hand over inventory items such as cameras or books whenever the gift card is presented. Or, perhaps, some service is due to the cardholder such as the repair of a computer or a massage. To the seller, a gift card reflects a liability but one that is not normally settled with cash. Undoubtedly, the most common type of gift card in the world is a postal stamp. When bought, the stamp provides a person with the right to receive a particular service, the mailing of a letter or package.

To illustrate, assume that a company sells ten thousand gift cards with a redemption value of \$50 each. Revenue cannot be reported at the time of sale; the earning process is not yet substantially complete. No asset or service has been conveyed to the customer. Rather, as shown in Figure 13.5 "Sale of Ten Thousand \$50 Gift Cards for Cash", a liability (labeled as “unearned revenue” or “gift card liability”) is recognized to indicate that the company has an obligation to the holder of the card.

Figure 13.5 Sale of Ten Thousand \$50 Gift Cards for Cash

Cash	500,000	
Unearned Revenue		500,000

Over time, customers will present their gift cards for selected merchandise. To complete this illustration, assume that a person uses one of the \$50 cards to acquire goods that had originally cost the company \$32. Upon redemption, the liability is satisfied and the revenue is recognized. This exchange is reported in Figure 13.6 "Redemption of Gift Card". A perpetual inventory system is used in this example to demonstrate the impact on inventory and cost of goods sold.

Figure 13.6 Redemption of Gift Card

Unearned Revenue	50	
Revenue		50
Cost of Goods Sold	32	
Inventory		32

Accounting for Gift Cards That Are Never Redeemed

Question: Some gift cards are never redeemed. They might be lost or just forgotten by their owners. Does the liability for a gift card remain on a company's balance sheet indefinitely if it is unlikely that redemption will ever occur?

Answer: One reason that gift cards have become so popular with businesses is that some percentage will never be redeemed. They will be misplaced, stolen, or the holder will move away or die. Perhaps the person simply does not want the merchandise that is available. In such cases, the seller received money but has never had to fulfill the obligation. The entire amount of cash from the sale of the gift card is profit.

For the accountant, a question arises as to the appropriate timing of revenue recognition from such anticipated defaults. The earning process is never substantially completed by a redemption. In theory, a company recognizes this revenue when reasonable evidence exists that the card will never be used by the customer. Practically, though, determining this precise point is a matter of speculation.

Companies typically report the revenue from unused gift cards at one of three possible times:

1. When the cards expire if a time limit is imposed.
2. After the passage of a specified period of time such as eighteen months or two years.
3. In proportion to the cards that are actually redeemed. To illustrate this final option, assume that a company sells thousands of cards. Based on historical trends, company officials believe that \$8,000 of these gift cards will never be turned in by their owners. If 10 percent of the expected gift cards are redeemed this month, the company can also reclassify \$800 (10 percent of \$8,000) from unearned revenue to revenue to reflect the estimated portion of those cards that will never be presented.

Because of this accounting issue, a note to the financial statements produced by **Best Buy** explains, "We recognize revenue from gift cards when: (i) the gift card is redeemed by the customer, or (ii) the likelihood of the gift card being redeemed by the customer is remote ('gift card breakage'), and we determine that we do not have

a legal obligation to remit the value of unredeemed gift cards to the relevant jurisdictions. We determine our gift card breakage rate based upon historical redemption patterns.”

TEST YOURSELF

Question:

The Boston Book Company (BBC) sells \$700,000 of gift cards during Year One. Of this amount, 60 percent are redeemed before the end of the year and properly recorded. Another 4 percent expired because of time limitations. The others remain outstanding at the end of the year. The accountant for BBC did not realize that the time limitations had been reached so made no entry for the 4 percent. What is the result of the accountant’s failure to make an entry?

- a. Revenues are overstated.
- b. Net income is overstated.
- c. Liabilities are overstated.
- d. There is an impact on liabilities but not on net income.

Answer:

The correct answer is choice c: Liabilities are overstated.

Explanation:

When the gift cards were sold, the total amount was recorded as a liability to indicate that the company owed a service or an asset to the customer. At the time of redemption or expiration, this liability should have been reclassified as revenue. That adjustment was not made for the cards that had expired. The liability was not properly reduced. It remains too high while revenue (and, hence, net income) is understated because of the failure to recognize this amount.

KEY TAKEAWAY

Companies report a wide variety of current liabilities. Accounts payable are normally created by the purchase of inventory or supplies. Accrued liabilities such as rent and interest are those debts that grow gradually over time. All such liabilities must be found and recorded prior to the preparation of financial statements. One common liability is created by the sale of gift cards. In today's retail world, many companies offer these cards in hopes of increasing profits. Because a product or service must be provided when the card is presented, the company has an obligation so that a liability is reported. This liability is later reclassified as revenue when the card is redeemed because the earning process is substantially complete at that point. Revenue should also be recorded for a gift card when it becomes likely that redemption will never occur. Cards can be lost, stolen, or the customer might die or leave the area. The revenue associated with unredeemed gift cards must be reported at an appropriate point in time such as on the date of expiration or in proportion to the redemption of other cards.

13.3 Accounting for Contingencies

LEARNING OBJECTIVES

At the end of this section students should be able to meet the following objectives:

1. Define a commitment and explain the method by which it is reported.
2. Define a contingency and explain the method by which it is reported.
3. Explain the criteria that guide the reporting of a contingent loss.
4. Describe the appropriate accounting for contingent losses that do not qualify for recognition at the present time.
5. Describe the handling of a contingent loss that ultimately proves to be different from the originally estimated and recorded balance.
6. Compare the reporting of contingent losses and contingent gains.

Commitments and Contingencies

Question: The December 31, 2010, balance sheet for E. I. du Pont de Nemours and Company (better known as DuPont) shows total liabilities of approximately \$30.7 billion. Immediately following the liability section, a separate category titled “Commitments and Contingent Liabilities” is included but no monetary figure is presented. Note 19 to the company’s financial statements provides further details. In several pages of explanatory material, a number of future matters facing the company are described such as product warranties, environmental actions, litigation, and operating leases. In financial reporting, what is meant by the terms “commitments” and “contingencies?”

Answer:

7. An unexecuted contract such as for the future purchase of inventory at a set price; amounts are not reported on the balance sheet or income statement because no transaction has yet occurred; disclosure of information within the financial statement notes is necessary.

Commitments. Commitments represent unexecuted contracts. A contract has been created (either orally or in writing) and all parties have agreed to the terms. However, the listed actions have not yet been performed.

For example, assume that a business places an order with a truck company for the purchase of a large truck. The business has made a **commitment**⁷ to pay for this new vehicle but only after delivery has been received. Although a cash payment will

be required in the future, the specified event (conveyance of the truck) has not occurred. No transaction has taken place, so no journal entry is needed. The liability does not yet exist.

Information about such commitments is still of importance to decision makers because future cash payments will be required of the reporting company. However, events have not reached the point where all the characteristics of a liability are present. Thus, an extensive explanation about such commitments (as found in the notes for **DuPont**) is included in the notes to financial statements but no amounts are reported on either the income statement or the balance sheet. When a commitment is described, investors and creditors know that a step has been taken that will likely lead to a liability.

Contingencies. A **contingency**⁸ poses a different reporting quandary for the accountant. A past event has already occurred but the amount of the present obligation (if any) cannot yet be determined.

With a contingency, the uncertainty is about the ultimate outcome of an action that took place in the past. The accountant is not a fortune teller who can predict the future. To illustrate, assume Wsocki Corporation commits an act that is detrimental to the environment so that the federal government files a lawsuit for damages. The original action against the environment is the past event that creates the contingency. However, both the chance of losing the lawsuit and the possible amount of any penalties might not be known for several years. What, if anything, should be recognized in the interim?

Because companies prefer to avoid (or at least minimize) the recognition of losses and liabilities, authoritative guidelines are necessary to guide the appropriate reporting of contingencies. Otherwise, few if any contingencies would ever be reported.

8. A potential gain or loss that might eventually arise as a result of a past event; uncertainty exists as to the likelihood that a gain or loss will occur and the actual amount, if any, that will result.

9. A potential loss resulting from a past event that must be recognized on an entity's financial statements if it is deemed probable and the amount can be reasonably estimated.

According to U.S. GAAP, the recognition of a **loss contingency**⁹ is required if the following are true:

1. The loss is deemed to be probable.
2. The amount of that loss can be reasonably estimated.

As soon as both of these criteria are met, the expected impact of the loss contingency must be recorded.

To illustrate, assume that the previous lawsuit for environmental damages was filed in Year One. Wysocki officials assess the situation. They believe that a loss is probable and that \$800,000 is a reasonable estimation of the amount that will eventually have to be paid as a result of this litigation. Although this balance is only an estimate and the case may not be finalized for some time, the contingent loss is recognized, as can be seen in [Figure 13.7 "Year One—Expected Loss from Lawsuit \(Contingency\)"](#).

Figure 13.7 Year One—Expected Loss from Lawsuit (Contingency)

Loss from Lawsuit—Estimated Estimated Liability from Lawsuit	800,000	800,000
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FASB has identified a number of examples of loss contingencies that are evaluated and reported in this same manner including:

- Collectability of receivables
- Obligations related to product warranties and product defects
- Risk of loss or damage of enterprise property by fire, explosion, or other hazards
- Threat of expropriation of assets
- Pending or threatened litigation
- Actual or possible claims and assessments
- Guarantees of indebtedness of others

Accounting Rules Used to Record Contingent Losses

Question: The likelihood of loss in connection with contingencies is not always going to be probable or subject to a reasonable estimation. These two criteria will be met in some but certainly not in all cases. What reporting is appropriate for a loss contingency that does not qualify for recording at the present time?

Answer: If a contingent loss is only reasonably possible (rather than probable) or if the amount of a probable loss does not lend itself to a reasonable estimation, only disclosure in the notes to the financial statements is necessary rather than actual recognition. Furthermore, a contingency where the chance of loss is viewed as merely remote can be omitted entirely from the financial statements.

Unfortunately, as discussed previously, official guidance provides little specific detail about what constitutes a probable, reasonably possible, or remote loss. At best, each of those terms seems vague. For example, within U.S. GAAP, “probable” is described as “likely to occur.” Thus, the professional judgment of the accountants and auditors must be relied on to determine the exact point in time when a contingent loss moves from reasonably possible to probable.

Not surprisingly, many companies contend that any future adverse effects from loss contingencies are only reasonably possible so that no actual amounts are reported on the balance sheet. Practical application of official accounting standards is not always theoretically pure, especially when the guidelines are nebulous.

Fixing an Incorrect Estimate

Question: Assume that a company recognizes a contingent loss because it is judged as probable and subject to a reasonable estimation. Eventually, most such guesses are likely to prove to be wrong, at least in some small amount. What happens when an estimate is reported in a set of financial statements and the actual total is later found to be different?

For example, as shown in [Figure 13.7 "Year One—Expected Loss from Lawsuit \(Contingency\)"](#), Wysocki Corporation recognized a loss of \$800,000 in Year One because of a lawsuit involving environmental damage. Assume the case is eventually settled in Year Two for \$900,000. How is the additional loss of \$100,000 reported? It relates to an action taken in Year One but the actual amount is not finalized until Year Two. The difference is not apparent until the later date.

Answer: In Year One, because both criteria for reporting were met, an \$800,000 loss was recognized on the income statement along with a corresponding liability. In addition, notes to the company’s financial statement will explain the nature of this lawsuit as well as the range of any reasonably possible losses. Decision makers analyzing the Wysocki Corporation should realize that the amount reported is not meant as a precise measure of the eventual loss. The same is true of all contingencies and other estimations. By the time that the exact amount of loss is determined, investors and creditors have already incorporated the original information into their decisions, including the uncertainty of the outcome. Restating the Year One loss to \$900,000 does not allow them to undo and change decisions that were made in the past.

Consequently, no alteration is made in the \$800,000 figure reported for Year One. The additional \$100,000 loss is recorded in Year Two. The adjustment is recognized as soon as a better estimation (or final figure) is available. This approach is required to correct any reasonable estimate. Wysocki recognizes the updated balances through the journal entry shown in [Figure 13.8 "Year Two—Settlement of Lawsuit at an Amount \\$100,000 More than Originally Reported"](#) that removes the liability and records the remainder of the loss that has now been incurred.

Figure 13.8 Year Two—Settlement of Lawsuit at an Amount \$100,000 More than Originally Reported

Estimated Liability from Lawsuit	800,000	
Additional Loss on Lawsuit	100,000	
Cash		900,000

One important exception to this handling does exist. If the initial estimate is viewed as fraudulent—an attempt to deceive decision makers—the \$800,000 figure reported in Year One is physically restated. It simply cannot continue to appear. All amounts in a set of financial statements have to be presented in good faith. Any reported balance that fails this essential test cannot be allowed to remain. Furthermore, even if company officials made no overt attempt to deceive, restatement is still required if they should have known that a reported figure was materially wrong. Such amounts were not reported in good faith; officials have been grossly negligent in reporting the financial information.

From a journal entry perspective, restatement of a previously reported income statement balance is accomplished by adjusting retained earnings. Revenues and expenses (as well as gains, losses, and any dividends paid figures) are closed into retained earnings at the end of each year. Thus, this account is where the previous year error now resides.

Upon discovery that the actual loss from the lawsuit is \$900,000, this amount is reported by one of the two approaches presented in [Figure 13.9 "Two Ways to Correct an Estimate"](#). However, use of the second method is rare because accounting mistakes do not often reach this level of deceit or incompetence. An announcement that a company has had to “restate its earnings” is never a good sign.

Figure 13.9 Two Ways to Correct an Estimate

<u>Original Estimation Was Reasonable, Made in Good Faith</u>		
	<u>Year One</u> <u>Income Statement</u>	<u>Year Two</u> <u>Income Statement</u>
Loss on Lawsuit	\$800,000	\$100,000
<u>Original Estimation Was Not Made in Good Faith (Restatement Required)</u>		
	<u>Year One</u> <u>Income Statement</u>	<u>Year Two</u> <u>Income Statement</u>
Loss on Lawsuit	\$900,000	-0-

TEST YOURSELF

Question:

The Red Company incurs a contingency in Year One. At that time, the company's accountants believe that a loss of \$200,000 is probable but a loss of \$290,000 is reasonably possible. Nothing is settled by the end of Year Two. On that date, the accountants believe that a loss of \$240,000 is probable but a loss of \$330,000 is reasonably possible. All these estimations are viewed as reasonable. The contingency ends in Year Three when Red Company pays the other party \$170,000 to settle the problem. What does Red Company recognize on its Year Three income statement?

- a. Gain (or Loss Recovery) of \$30,000
- b. Gain (or Loss Recovery) of \$70,000
- c. Gain (or Loss Recovery) of \$120,000
- d. Gain (or Loss Recovery) of \$160,000

Answer:

The correct answer is choice b: Gain (or Loss Recovery) of \$70,000.

Explanation:

A loss of \$200,000 is recognized in Year One because that amount is viewed as probable. An additional \$40,000 loss is recognized in Year Two so that the total loss reported to date corresponds to the estimated \$240,000 probable amount. However, the company does not lose all \$240,000 that has now been recognized but only \$170,000. The reduction in the reported loss increases net income by the \$70,000 difference and is shown as either a gain or a loss recovery.

Gain Contingencies

*Question: The previous discussion focused entirely on the accounting that is required for loss contingencies. Companies obviously can also have **gain contingencies**¹⁰. In a lawsuit, for example, one party might anticipate winning \$800,000 but eventually collect \$900,000. Are the rules for reporting gain contingencies the same as those applied to loss contingencies?*

10. A potential gain resulting from a past event that is not recognized in an entity's financial statements until it actually occurs due to the conservatism inherent in financial accounting.

Answer: As a result of the conservatism inherent in financial accounting, the timing used in the recognition of gains does not follow the same rules applied to losses. Losses are anticipated when they become probable; that has long been a fundamental rule of financial reporting. The recognition of gains is delayed until they actually occur (or, at least until they reach the point of being substantially complete). Disclosure in the notes is still important but the decision as to whether the outcome is probable or reasonably possible is irrelevant in reporting a gain. As reflected in Figure 13.10 "Reporting a Gain Contingency", gains are not anticipated for reporting purposes.

Figure 13.10 *Reporting a Gain Contingency*

	Year One <u>Income Statement</u>	Year Two <u>Income Statement</u>
Gain on Lawsuit	-0-	\$900,000

TEST YOURSELF

Question:

The Blue Company files a lawsuit against another company in Year One and thinks there is a good chance for a win. At that time, the company's accountants believe that a gain of \$200,000 is probable but a gain of \$290,000 is reasonably possible. Nothing is settled by the end of Year Two. On that date, the accountants believe that a gain of \$240,000 is probable but a gain of \$330,000 is reasonably possible. The contingency is settled in Year Three when Blue Company collects \$170,000. What does Blue Company recognize on its Year Three income statement?

- a. Decrease in income of \$30,000
- b. Decrease in income of \$70,000
- c. Decrease in income of \$120,000
- d. Increase in income of \$170,000

Answer:

The correct answer is choice d: Increase in income of \$170,000.

Explanation:

As a gain contingency, no amount will be recognized until the point where substantial completion is reached. Consequently, no gain or loss is reported in either Year One or Year Two despite the optimism that a gain will be achieved. Thus, the entire amount of the gain is recorded when the case is settled in Year Three. That final event increases net income by \$170,000.

Talking with an Independent Auditor about International Financial Reporting Standards

Following is a continuation of our interview with Robert A. Vallejo, partner with the accounting firm **PricewaterhouseCoopers**.

Question: According to U.S. GAAP, a contingent loss must be recognized when it is probable and a reasonable estimation of the amount can be made. That rule has been in place now for over thirty years and is well understood in this country. Are contingent losses handled in the same way by IFRS?

Robert Vallejo: The theory is the same under IFRS but some interesting and subtle differences do exist. If there is a probable future outflow of economic benefits and the company can form a reliable estimate, then that amount must be recognized. However, the term “probable” is defined as “more likely than not” which is easier to reach than the U.S. GAAP equivalent. Thus, the reporting of more contingent losses is likely under IFRS than currently under U.S. GAAP.

IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, states that the amount recorded should be the best estimate of the expenditure that would be required to settle the present obligation at the balance sheet date. That is the best estimate of the amount that an entity would rationally pay to settle the obligation at the balance sheet date or to transfer it to a third party. Under U.S. GAAP, if there is a range of possible losses but no best estimate exists within that range, the entity records the low end of the range. Under IFRS, the entity records the midpoint of the range. That is a subtle difference in wording, but it is one that could have a significant impact on financial reporting for organizations where expected losses exist within a very wide range.

In July 2010, the FASB published an exposure draft, *Disclosure of Certain Loss Contingencies*, as investors and other users of financial reporting had expressed concerns that disclosures about loss contingencies. Many felt that existing guidance does not provide adequate and timely information to assist them in assessing the likelihood, timing, and magnitude of future cash outflows associated with loss contingencies. After receiving comments from constituents, the FASB is re-deliberating the need to update existing U.S. GAAP.

KEY TAKEAWAY

Entities often enter into contractual arrangements. Prior to performing the requirements of the contract, financial commitments frequently exist. They are future obligations that do not yet qualify as liabilities. For accounting purposes, they are only described in the notes to the financial statements. In contrast, contingencies are potential liabilities that might result because of a past event. The likelihood of loss or the actual amount of the loss both remain uncertain. Loss contingencies are recognized when their likelihood is probable and this loss is subject to a reasonable estimation. Reasonably possible contingent losses are only described in the notes whereas potential losses that are only remote can be omitted entirely from a company's financial statements. Eventually, such estimates often prove to be incorrect and are normally fixed when first discovered. However, if fraud, either purposely or through gross negligence, has occurred, the amounts reported in prior years are restated. Contingent gains are only reported to decision makers through disclosure within the notes to the financial statements.

13.4 Accounting for Product Warranties

LEARNING OBJECTIVES

At the end of this section students should be able to meet the following objectives:

1. Explain the difference between an embedded and an extended product warranty.
2. Account for the liability and expense incurred by a company that provides customers with an embedded warranty on a purchased product.
3. Account for the amount received on the sale of an extended warranty and any subsequent costs incurred as a result of this warranty.
4. Compute the average age of accounts payable.

Accounting for Embedded Product Warranties

*Question: U.S. GAAP includes an **embedded product warranty**¹¹ as one type of loss contingency. A company sells merchandise such as a car or a microwave and agrees to fix certain problems if they arise within a specified period of time. The seller might promise, for example, to replace a car's transmission if it breaks. Making the sale with this warranty attached is the past event that creates the contingency. However, the item acquired by the customer must break before the company has an actual loss. That outcome is uncertain.*

In accounting for an embedded product warranty, several estimates are required:

- *The approximate number of claims that can be expected*
- *The percentage of these claims will meet the requirements of the warranty*
- *The eventual cost from the average approved claim*

As an example, General Electric reported on its December 31, 2010, balance sheet a liability for product warranties totaling over \$1.5 billion. That is certainly not a minor obligation. In the notes to the financial statements, the company explains, "We provide for estimated product warranty expenses when we sell the related products. Because warranty estimates are forecasts that are based on the best available information—mostly historical claims experience—claims costs may differ from amounts provided." How does a company record and report contingencies such as embedded product warranties?

11. An obligation established by the sale of a product where the seller promises to fix or replace the product if it proves to be defective.

Answer: In accounting for warranties, cash rebates, the collectability of receivables and other similar contingencies, the likelihood of loss is rarely an issue. These losses are almost always probable. For the accountant, the challenge is in arriving at a reasonable estimate of that loss. How many microwaves will break and have to be repaired? What percentage of cash rebate coupons will be presented by customers in the allotted time? How often will a car's transmission need to be replaced?

Many companies utilize such programs on an ongoing basis so that data from previous offers will be available to help determine the amount of the expected loss. However, historical trends cannot be followed blindly. Officials still have to be alert for any changes that could impact previous patterns. For example, in bad economic periods, customers are more likely to take the time to complete the paperwork required to receive a cash rebate. Or, the terms may vary from one warranty program to the next. Even small changes in the wording of an offer can alter the expected number of claims.

To illustrate, assume that a retail store sells ten thousand compact refrigerators during Year One for \$400 cash each. The product is covered by a warranty that extends until the end of Year Three. No claims are made in Year One but similar programs in the past have resulted in repairs having to be made on 3 percent of the refrigerators at an average cost of \$90. Thus, the warranty on the Year One sales is expected to cost a total of \$27,000 (10,000 units × 3 percent = 300 claims; 300 claims × \$90 each = \$27,000).

Although no repairs are made in Year One, the \$27,000 liability is reported in that period. Immediate recognition is appropriate because the loss is both probable and subject to reasonable estimation. In addition, the matching principle states that expenses should be reported in the same period as the revenues they help generate. Because the revenue from the sale of the refrigerators is recognized in Year One (Figure 13.11 "Year One—Sale of Ten Thousand Compact Refrigerators for \$400 Each"), the warranty expense resulting from those revenues is included at that time (Figure 13.12 "Year One—Recognize Expected Cost of Warranty Claims").

Figure 13.11 Year One—Sale of Ten Thousand Compact Refrigerators for \$400 Each

Cash	4,000,000	
Sales of Inventory		4,000,000

Figure 13.12 Year One—Recognize Expected Cost of Warranty Claims

Warranty Expense	27,000	
Warranty Payable		27,000

This warranty is in effect until the end of Year Three. Assume that repairs made in the year following the sale (Year Two) cost the company \$13,000 but are made for these customers at no charge. When a refrigerator breaks, it is fixed as promised by the warranty. Because the expense has already been recognized in the year of sale (Figure 13.12 "Year One—Recognize Expected Cost of Warranty Claims"), these payments reduce the recorded liability as is shown in Figure 13.13 "Year Two—Payment for Repair Work Covered by Embedded Warranty". The actual costs create no additional impact on net income.

Figure 13.13 Year Two—Payment for Repair Work Covered by Embedded Warranty

Warranty Payable	13,000	
Cash		13,000

At the end of Year Two, the liability balance in the general ledger holds a balance of \$14,000 to reflect the expected warranty costs for Year Three (\$27,000 original estimation less the \$13,000 payout made for repairs to date). Because the warranty has not expired, company officials need to evaluate whether this \$14,000 liability is still a reasonable estimation of the remaining costs to be incurred. If so, no further adjustment is made.

However, the original \$27,000 was merely an estimate. More information is now available, some of which might suggest that \$14,000 is no longer the best number to be utilized for the final year of the warranty. To illustrate, assume that a flaw has been found in the refrigerator's design and that \$20,000 (rather than \$14,000) is now a better estimate of the costs to be incurred in the final year of the warranty.

The \$14,000 balance is no longer appropriate. The reported figure is updated in Figure 13.14 "December 31, Year Two—Adjust Warranty Liability from \$14,000 to Newly Expected \$20,000" to provide a fair presentation of the data that is now available. Estimates should be changed at the point where new information provides a clearer vision of future events.

Figure 13.14 December 31, Year Two—Adjust Warranty Liability from \$14,000 to Newly Expected \$20,000

Warranty Expense		
Warranty Payable		
	6,000	6,000

In this adjusting entry, the change in the expense is not recorded in the period of the sale. As discussed earlier, no retroactive restatements are made to figures previously reported unless fraud occurred or an estimate was held to be so unreasonable that it was not made in good faith.

Accounting for Extended Product Warranties

*Question: Not all warranties are built into a sales transaction. Many retailers also offer **extended product warranties**¹² for an additional fee. For example, assume a business sells a high-definition television with an automatic one-year warranty. The buyer receives this warranty as part of the purchase agreement. The accounting for that first year is the same as just demonstrated; an estimated expense and liability are recognized at the time of sale.*

However, an additional warranty for three more years is also offered at a price of \$50. If on January 1, Year One, a customer buys a new television and also chooses to acquire this additional three-year coverage, what recording is made by the seller? Is an extended warranty purchased by a customer reported in the same manner as an automatic product warranty embedded within a sales contract?

Answer: Extended warranties, which are quite popular in many industries, are simply insurance policies. If the customer buys the coverage, the product is insured against breakage or other harm for the specified period of time. In most cases, the company is making the offer in an attempt to earn an extra profit. The seller hopes that the money received for the extended warranty will outweigh the eventual repair costs. Therefore, the accounting differs here from the process demonstrated previously for an embedded warranty that was provided to encourage the sale of the product. In that earlier example, all of the revenue as well as the related (but estimated) expense were recorded immediately.

12. An obligation whereby the buyer of a product pays the seller for the equivalent of an insurance policy to protect against breakage or other harm to the product for a specified period of time.

By accepting money for an extended warranty, the seller agrees to provide services in the future. This contract is much like a gift card. The revenue cannot be

recognized until the earning process is substantially complete. Thus, as shown in [Figure 13.15 "January 1, Year One—Sale of Extended Warranty Covering Years Two through Four"](#), the \$50 received for the extended warranty on this television is initially recorded as “unearned revenue.” This balance is a liability because the company owes a specified service to the customer. As indicated previously, liabilities do not always represent future cash payments.

Figure 13.15 January 1, Year One—Sale of Extended Warranty Covering Years Two through Four

Cash	50	
Unearned Revenue		50

Note in [Figure 13.15 "January 1, Year One—Sale of Extended Warranty Covering Years Two through Four"](#) that no expense was estimated and recorded in connection with this warranty. As explained by the matching principle, expenses are not recognized until the related revenue is reported.

Because of the terms specified, this extended warranty does not become active until January 1, Year Two. The television is then covered for a three-year period. The revenue is recognized, most likely on a straight-line basis, over that time. Consequently, the \$50 is reported at the rate of 1/3 per year or \$16.66.

Figure 13.16 December 31, Year Two (as well as Three and Four)—Recognition of Revenue from Extended Warranty

Unearned Revenue	16.66	
Revenue from Extended Warranty		16.66

In any period in which a repair must be made, the expense is recognized as incurred because revenue from this warranty contract is also being reported. For example, assume that on August 8, Year Two, a slight adjustment must be made to the television at a cost of \$9. The product is under warranty so the customer is not charged for this service. The Year Two expense shown in [Figure 13.17 "August 8, Year Two—Repair of Television under Warranty Contract"](#) is being matched with the Year Two revenue recognized in [Figure 13.16 "December 31, Year Two \(as well as Three and Four\)—Recognition of Revenue from Extended Warranty"](#).

Figure 13.17 August 8, Year Two—Repair of Television under Warranty Contract

Warranty Expense	9	
Cash		9

TEST YOURSELF

Question:

A company sells a product late in Year One. The customer holds a one-year warranty on that product. The company believes the product will break in Year Two and have to be repaired at a cost of \$16. Which of the following statements is true?

- a. If this is an embedded warranty that the customer received automatically when the product was acquired, the \$16 expense is reported in Year One.
- b. If this is an extended warranty that the customer bought when the product was acquired, the \$16 expense is reported in Year One.
- c. If this is an extended warranty that cost the customer \$20, the company recognizes a \$4 profit in Year One.
- d. If this is an embedded warranty that the customer received automatically when the product was acquired, revenue is recognized by the company in Year Two.

Answer:

The correct answer is choice a: If this is an embedded warranty that the customer received automatically when the product was acquired, the \$16 expense is reported in Year One.

Explanation:

For an embedded warranty that comes with the purchase of a product, the expense (and related liability) is recognized immediately and no revenue is recorded for the warranty. For an extended warranty acquired by the customer, revenue is recognized over the period of coverage (like an insurance policy), and the expense is recognized as incurred. If an extended warranty was sold for \$20, the expense and virtually all the revenue are reported in Year Two.

13. Formula measuring an organization's liquidity (the ability to pay debts as they come due); calculated by subtracting current liabilities from current assets.

Computing the Age of Accounts Payable

*Question: Previously, the current ratio (current assets divided by current liabilities) and the amount of **working capital**¹³ (current assets minus current liabilities) were discussed. Do investors and creditors analyze any other vital signs when analyzing the current liabilities*

reported by a business or other organization? Should decision makers be aware of any specific ratios or amounts in connection with current liabilities that provide especially insightful information about a company's financial health and operations?

Answer: In studying current liabilities, the number of days a business takes to pay its accounts payable is usually a figure of interest. If a business begins to struggle, the time of payment tends to lengthen because of the difficulty in generating sufficient cash amounts. Therefore, an unexpected jump in this number is often one of the first signs of financial distress and warrants concern.

To determine the **age of accounts payable**¹⁴ (or the number of days in accounts payable), the amount of inventory purchased during the year is first calculated:

cost of goods sold = beginning inventory + purchases – ending inventory.

Thus,

purchases = cost of goods sold – beginning inventory + ending inventory.

Using this computed purchases figure, the number of days that a company takes to pay its accounts payable on the average can be determined. Either the average accounts payable for the year can be used or just the ending balance.

purchases/365 = average purchases per day

accounts payable/average purchases per day = average age of accounts payable

As an illustration, the information presented in [Figure 13.18 "Information from 2010 Financial Statements for Safeway Inc."](#) comes from the 2010 financial statements for **Safeway Inc.**

Figure 13.18 Information from 2010 Financial Statements for Safeway Inc.

Beginning Inventory	\$2.509 billion
Ending Inventory	\$2.623 billion
Cost of Goods Sold	\$29.443 billion
Ending Accounts Payable	\$2.533 billion

14. A determination of the number of days that a company takes to pay for the inventory that it buys; computed by dividing accounts payable by the average inventory purchases made per day during the period.

The total amount of inventory purchased by Safeway during 2010 was over \$29 billion:

purchases = cost of goods sold – beginning inventory + ending inventory

purchases = \$29.443 billion - \$2.509 billion + \$2.623 billion

purchases = \$29.557 billion.

The average purchases amount made each day during 2010 by **Safeway** was nearly \$81 million:

purchases/365

\$29.557/365 = \$80.978 million.

The average age of the reported accounts payable for **Safeway** at the end of 2010 was between thirty-one and thirty-two days:

accounts payable/average daily purchases

\$2.533 billion/\$80.978 million = 31.28 days.

To evaluate that number, a decision maker needs to compare it to (a) previous time periods for that company, (b) the typical payment terms for a business in that particular industry, and (c) comparable figures from other similar corporations. Interestingly, the same computation for 2008 showed that **Safeway** was taking 28.48 days to pay its accounts payable during that earlier period.

KEY TAKEAWAY

Many companies incur contingent liabilities as a result of product warranties. If the warranty is given to a customer along with a purchased item, an anticipated expense should be recognized at that time along with the related liability. If the reported cost of this type of embedded warranty eventually proves to be wrong, a correction is made when discovered assuming that the original estimate was made in good faith. Companies also sell extended warranties, primarily as a means of increasing profits. These warranties are recorded initially as liabilities (unearned revenue) with that amount reclassified to revenue over the time of the obligation. Subsequent costs are expensed as incurred to be in alignment with the matching principle. Thus, for extended warranties, expenses are not estimated and recorded in advance. Analysts often calculate the average age of accounts payable to determine how quickly liabilities are being paid as a vital sign used to indicate an entity's financial health.

Talking with a Real Investing Pro (Continued)

Following is a continuation of our interview with Kevin G. Burns.

Question: Analysts often look closely at current liabilities when evaluating the future prospects of a company. Is there anything in particular that you look for when examining a company and the reported balances for its current liabilities?

Kevin Burns: For almost any company, there are a number of things that I look at in connection with current liabilities. I always have several questions where possible answers can concern me. I am interested in the terms of the current liabilities as well as the age of those liabilities. In other words, is the company current with its payments to vendors? Does the company have a significant amount of current liabilities but only a small amount of current assets? Or, stated more directly, can these liabilities be paid on time? Have current liabilities been growing while business has remained flat or grown much more slowly? Are any of the current liabilities to organizations controlled by corporate insiders? That always makes me suspicious so that, at the very least, I want more information. In sum, I like balance sheets where there are no potential conflicts of interest and the company is a reasonably fast payer of its debts.

Video Clip

[\(click to see video\)](#)

Professor Joe Hoyle talks about the five most important points in [Chapter 13 "In a Set of Financial Statements, What Information Is Conveyed about Current and Contingent Liabilities?"](#).

13.5 End-of-Chapter Exercises

QUESTIONS

1. The Saint Louis Corporation is trying to determine whether a liability needs to be recognized in connection with an event that recently took place. What characteristics must be present before a liability has to be reported?
2. The Topeka Company has a liability for \$1.3 million. Company officials are trying to decide whether the debt should be shown as a current or noncurrent liability. How is that decision made?
3. Why are most decision makers particularly concerned about the amount of current liabilities reported by a company?
4. The Ames Company reports \$300,000 in current assets and \$100,000 in current liabilities. At the very end of the year, the company pays a \$20,000 account payable. What was the current ratio before the payment? What was the current ratio after the payment?
5. What are several examples of accrued liabilities? Why do they often require adjusting entries prior to the production of financial statements?
6. How do companies account for gift cards that they sold?
7. How do companies account for gift cards that are redeemed?
8. How do companies account for gift cards that are unlikely to be redeemed?
9. In financial reporting, what is a commitment, and how is it shown within a set of financial statements? Why is that reporting considered appropriate?
10. The Atkinson Company has a contingent loss at December 31, Year One. It will not be completely settled for at least two years. Under what condition, should the company report a liability at the present time?
11. Give three examples of possible contingencies that a company might have to report in its financial statements.
12. The Salem Corporation has been sued for \$2 million. Company lawyers believe that the chances of a loss are only reasonably possible. If a loss is incurred, the expected amount is \$775,000. What does Salem report in connection with this contingency?
13. The Oregon Company has been sued for \$3 million. Company lawyers believe that a loss of \$500,000 might result, but the chances of such a loss are really remote. How does Oregon report this contingent loss?
14. The Randolph Corporation is being sued for \$2 million. How does the reporting under U.S. GAAP differ from the reporting required under IFRS?
15. The Remshaw Corporation has filed suit against a competitor for patent infringement. Company lawyers are confident of a positive outcome.

They believe that an award of \$1.2 million is probable. How does Remshaw report this contingent gain?

16. A landscaping company sells live plants (such as azaleas) and promises to replace any plants that die within one year of purchase. At the end of the current fiscal year, how does the company determine the amount that must be reported as its liability?
17. A company sells computers and promises to fix any problems that the customer encounters within two years of a purchase. When does the company recognize expense from this warranty program?
18. A company sells computers and also sells an extended warranty that obligates the company to fix any problems that are encountered within two years from the purchase date. When does the company recognize expense from this warranty program?
19. How is the age of accounts payable calculated?

TRUE OR FALSE

1. ____ A company has a liability, and company officials are not sure if it should be reported as a current liability or as a noncurrent liability. They are likely to prefer to report the balance as a current liability.
2. ____ A current ratio of less than 1.0 to 1.0 means that a company has more current assets than current liabilities.
3. ____ A company signs a contract on December 29, Year One, to buy 1,000 barrels of crude oil on January 24, Year Two, at \$82 per barrel. The likelihood of this contingency is probable and, therefore, should be reported as a liability at the end of Year One.
4. ____ Contingent liabilities should be reported on the balance sheet if they are both probable and can be reasonably estimated.
5. ____ Because of conservatism, a contingent liability should be disclosed in a company's financial statements even if the chance of loss is only remote.
6. ____ Contingent gains should only be recorded if they are probable.
7. ____ Liabilities for gift cards must remain on the balance sheet until they are redeemed, regardless of how long that takes.
8. ____ If a gift card is redeemed, a liability is reduced for reporting purposes.
9. ____ Restatement of previously issued financial statements will occur if a company attempts to mislead investors by understating liabilities.
10. ____ A company has a contingent loss of \$1 million. If a liability is reported using IFRS, the same monetary liability will also have to be reported according to U.S. GAAP.
11. ____ A company has both embedded product warranties and extended product warranties. These warranties will be reported in the same way by this company.
12. ____ A company gives customers an embedded warranty with each purchase. During the past several years, 4 percent of these products have been returned under the warranty program. Thus, the company should anticipate that 4 percent of the items sold this year will have to be fixed.
13. ____ Company A takes twenty-two days to pay its accounts payable. Company Z takes thirty-one days to pay its accounts payable. Company A is a more financially healthy company than Company Z.

MULTIPLE CHOICE

1. Which of the following is **not** a criterion that must be met for an item to be classified as a liability?
 - a. A certain cash payment will occur in the future.
 - b. A sacrifice will require the entity's assets or services.
 - c. There is a probable future sacrifice.
 - d. There is a present obligation that results from a past transaction.

2. Watkins Inc. has the following assets at the end of Year One:

Cash	\$400
Inventory	\$730
Prepaid Rent	\$460
Equipment (net book value)	\$4,000

Watkins also has the following liabilities at the end of Year One:

Accounts Payable	\$560
Rent Payable	\$200
Note Payable, due on June 1, Year Four	\$3,500

At the end of Year One, what is Watkins's current ratio?

- a. 1.14 to 1.0
 - b. 1.31 to 1.0
 - c. 1.49 to 1.0
 - d. 2.09 to 1.0

3. Which of the following is the least likely to be an accrued liability?
 - a. Accounts payable
 - b. Interest payable
 - c. Rent payable

- d. Salary payable
4. The Taylor Company sells music systems. Each music system costs the company \$100 and will be sold to the public for \$250. In Year One, the company sells 100 gift cards to customers for \$250 each (\$25,000 in total). These cards are valid for just one year, and company officials expect them to all be redeemed. In Year Two, only 96 of the cards are returned. What amount of net income does the company report for Year Two in connection with these cards?
- a. \$15,000
 - b. \$15,400
 - c. \$15,500
 - d. \$15,800
5. Osgood sells music systems. Each system costs the company \$100 and is sold for \$250. During Year One, the company sells 1,000 of these systems (\$250,000 in total). Each system comes with a free one-year warranty. The company expects 5 percent of the music systems to break and cost \$40 each to fix. None break in Year One, but unfortunately, the systems were not well-manufactured, and 300 break in Year Two and cost \$70 each to fix. What is the impact of this embedded warranty on Osgood's reported net income for Year Two?
- a. Decrease of \$15,000
 - b. Decrease of \$17,000
 - c. Decrease of \$19,000
 - d. Decrease of \$21,000
6. The James Corporation sells music systems. Each system costs the company \$100 and is sold for \$250. During Year One, the company sold 1,000 music systems (\$250,000 in total). Every customer also paid \$10 each (\$10,000 in total) for a one-year warranty. The company expects 5 percent of the music systems to break and cost \$40 each to fix. None break in Year One, but unfortunately, the systems were not well-manufactured, and 300 break in Year Two and cost \$70 each to fix. What is the impact of this extended warranty on James's reported net income for Year Two?

- a. Decrease of \$10,000
 - b. Decrease of \$11,000
 - c. Decrease of \$18,000
 - d. Decrease of \$21,000
7. In Year One, Company A was allegedly damaged by Company Z and has filed suit for \$300,000. At the end of Year One, Company A thinks it is probable that it will win \$130,000 but reasonably possible that it will win \$200,000. On that same day, Company Z thinks it is probable that it will lose \$80,000 but reasonably possible that it will lose \$180,000. On June 14, Year Two, the suit is settled when Company Z pays \$97,000 in cash to Company A. Which of the following is true about the financial reporting for Year Two?
- a. Company A increases net income by \$97,000; Company Z decreases net income by \$17,000.
 - b. Company A increases net income by \$97,000; Company Z increases net income by \$83,000.
 - c. Company A decreases net income by \$33,000; Company Z decreases net income by \$17,000.
 - d. Company A decreases net income by \$33,000; Company Z increases net income by \$83,000.
8. Stimpson Corporation buys cameras for \$500 apiece and then sells each one for \$1,200. During Year One, 9,000 units were sold. Each sale includes a one-year warranty. Stimpson estimates that 6 percent of the cameras will break (all during Year Two) and have to be fixed at an estimated cost of \$190 each. In Year Two, no additional cameras are sold, but 590 cameras actually break but only cost \$180 each to fix. What expense should Stimpson recognize for Year Two?
- a. \$3,600
 - b. \$5,900
 - c. \$9,000
 - d. \$9,500
9. The Greene Company sells appliances along with an embedded warranty. In Year One, the company recognizes a warranty expense of \$54,000. In Year Two, the company has an actual

expense that is different than \$54,000. Under what condition will the company restate the number reported for Year One?

- a. Under no condition.
 - b. If the original estimate was discovered to be too low.
 - c. If the original estimate was not made by company officials in good faith.
 - d. If the original estimate was discovered to be too high.
10. The Knafo Company sells toaster ovens for \$50 apiece. The company also planned to sell a one-year warranty with each purchase for \$3. Company officials believe that 10 percent of all toaster ovens will break during Year Two and cost \$7 each to fix. The company expects 40 percent of its customers to buy this extended warranty. At the last moment, company officials decide to give all customers a free one-year warranty to create customer loyalty. During Year One, the company sells 1,000 units. In Year Two, 11 percent of all toasters broke. Each repair cost \$7. Because of the decision to give the warranty to all customers for free, the company will report a lower net income in Year One. How much lower will the net income figure be for Year One because of this decision?
- a. \$298
 - b. \$400
 - c. \$700
 - d. \$1,200
11. Use the information in problem 10 again. Because of the decision to give the warranty to all customers for free, the company will report a lower liability at the end of Year One. How much lower will the liability be at the end of Year One because of this decision?
- a. \$500
 - b. \$700
 - c. \$900
 - d. \$1,200
12. Use the information in problem 10 again. Because of the decision to give the warranty to all customers for free, the company will

report a lower net income in Year Two. How much lower will the net income figure be in Year Two because of this decision?

- a. \$320
 - b. \$468
 - c. \$648
 - d. \$962
13. On January 1, Year One, Purple Company sues Yellow Company for \$6 million. At the end of Year One, both companies think that the probable outcome of this lawsuit is a settlement for \$170,000. They also believe that a settlement of \$290,000 is reasonably possible while a settlement of \$540,000 is possible but remote. In Year Two, the lawsuit is settled with Purple winning exactly \$120,000. Which of the following is correct about the reporting for Year Two?
- a. Purple recognizes a loss of \$50,000; Yellow recognizes a gain (a recovery) of \$50,000.
 - b. Purple recognizes a gain of \$120,000; Yellow recognizes a gain (a recovery) of \$50,000.
 - c. Purple recognizes a gain of \$120,000; Yellow recognizes a loss of \$120,000.
 - d. Purple recognizes a loss of \$50,000; Yellow recognizes a loss of \$120,000.
14. Langston Corporation is being sued by a competitor for \$1 million. At the end of the year, company officials believe that there is a 51 percent chance of a loss of \$420,000 from this lawsuit. Which of the following statements is true?
- a. Under both U.S. GAAP and IFRS, a liability of \$420,000 is recognized.
 - b. Under U.S. GAAP (but not under IFRS), a liability of \$420,000 is recognized.
 - c. Under IFRS (but not under U.S. GAAP), a liability of \$420,000 is recognized.
 - d. Under both U.S. GAAP and IFRS, no liability is recognized at this time.

15. Maxout Company sells computers. Customers have the option to buy an extended warranty that covers their computer for two years. To get the extended warranty, the customer must pay \$200. Maxout expects every computer will have to be fixed during the warranty period at a cost of \$100. What journal entry will Maxout make at the time the computer is purchased, assuming the customer buys the extended warranty?

a. *Figure 13.19*

Warranty Expense	100	
Warranty Liability		100

b. *Figure 13.20*

Cash	200	
Unearned Revenue		200

c. *Figure 13.21*

Unearned Revenue	100	
Revenue		100

d. *Figure 13.22*

Cash	200	
Revenue		200

16. Sierra Inc. manufactures environmentally friendly appliances. It provides a four-year warranty as a standard part of each purchase. In Year One, Sierra sold 450,000 toasters. Past experience has shown that 4 percent of the toasters usually require repair at an average cost of \$10 each. During Year One, Sierra actually spends \$38,000 on repairs and during Year Two, Sierra spends another \$65,000. What is the balance in the warranty liability account at the end of Year Two?
- \$67,000
 - \$77,000

- c. \$84,000
- d. \$94,000

17. The following figures appear on LaGrange's financial statements for the most recent fiscal year:

Cost of goods sold	\$1,960,000
Beginning inventory	238,000
Ending inventory	278,000
Accounts payable	182,000

What is the age of this company's accounts payable?

- a. 33.2 days
- b. 33.9 days
- c. 34.7 days
- d. 35.3 days

VIDEO PROBLEMS

Professor Joe Hoyle discusses the answers to these two problems at the links that are indicated. After formulating your answers, watch each video to see how Professor Hoyle answers these questions.

1. Your roommate is an English major. The roommate's parents own a chain of ice cream shops located throughout Florida. One day, while returning a book at the library, your roommate poses this question: "My parents came up with this great idea. They started selling gift cards this year right before Christmas. A lot of our older customers bought bunches of these cards to give to their children and grandchildren as presents. This was one of my parent's best ideas ever; the money really poured into each of the shops. However, when I asked my parents about their net income for the year, they said that these sales had not affected net income. That makes absolutely no sense. They sold thousands of gift cards for ice cream and got real money. How could their net income have not gone up through the roof?" How would you respond?

[\(click to see video\)](#)

2. Your uncle and two friends started a small office supply store several years ago. The company has expanded and now has several large locations. Your uncle knows that you are taking a financial accounting class and asks you the following question: "We are about to start selling a new line of office equipment. We really want to get our customers to consider this merchandise. We have been thinking about giving a free two-year warranty with each purchase. That eliminates risk and makes people feel more comfortable about the purchase. However, one of the other owners wants to charge a small amount for this warranty just so that we can make a small profit. We still take away the risk, but we also increase our net income. The decision is important, so I want to understand: how will each of these two alternatives affect the way our company looks on its balance sheet and income statement?" How would you respond?

[\(click to see video\)](#)

PROBLEMS

1. Knockoff Corporation sells a videogame unit known as the Gii. During the month of December, the following events occur. Prepare any necessary journal entries and adjusting entries that Knockoff should record.
 - a. Knockoff purchased \$300,000 of inventory on account.
 - b. The company incurs salary expense of \$45,000, although employees will not be paid until the beginning of January. The company also owes an additional \$7,000 to the government for payroll taxes.
 - c. Knockoff determines that it owes the IRS \$120,000 in income taxes for this year.
 - d. A retail customer places an advance order for Giis and pays Knockoff \$23,000. The Giis will be shipped in January.
 - e. Knockoff owes a local bank \$4,000 in interest on a loan.
 - f. Knockoff rents a warehouse of \$3,000 per week. No payments were made for the last three weeks of the year.

2. OK Corporation sells gift cards in various denominations. The company likes to sell these cards because cash is collected immediately, but a certain percentage will never be redeemed for merchandise. On December 1, Year One, OK reported a balance in unearned revenue of \$728,000 from the sale of gift cards.
 - a. During December, OK sold an additional \$578,000 in gift cards. Prepare this journal entry.
 - b. During December, gift cards totaling \$327,000 were redeemed to purchase inventory that had originally cost OK \$190,000. Prepare these journal entries. Assume OK uses a perpetual inventory system.
 - c. On December 31, OK's accountant determines that 3 percent of the outstanding gift cards will never be redeemed because they have expired. Prepare a journal entry if necessary.
 - d. What is the amount reported by OK on its December 31, Year One, balance sheet for unearned revenues?

3. In Year One, the Yankee Corporation allegedly damaged the Sox Corporation. The Sox Corporation sued the Yankee Corporation

for \$1 million. At the end of Year One, both companies believed that an eventual payment of \$300,000 by Yankee was probable, but a payment of \$480,000 was reasonably possible. The case moved through the court system rather slowly, and at the end of Year Two, both companies had come to believe that an eventual payment of \$340,000 by Yankee was now probable, but a payment of \$700,000 was reasonably possible. In Year Three, this lawsuit is settled for \$275,000 in cash.

- a. Determine the income effect to be reported by each company for each of these three years.
 - b. Discuss how the financial reporting might be different if these companies were reporting according to IFRS instead of U.S. GAAP.
4. Whalens Corporation buys large screen televisions for \$500 each and sells them for \$1,200 each. During Year One, 8,000 sets were bought and sold for cash. Whalens estimates that 1 percent of all sets will break during Year Two. Company officials believe they will cost \$150 to fix. Whalens offers a one-year warranty for \$40. A total of only 700 customers choose to buy the warranty. In Year Two, nine of the televisions under warranty break but cost only \$140 to repair.
- a. At the end of Year One, what revenue and expense should Whalens report in connection with this warranty?
 - b. At the end of Year Two, what revenue and expense should Whalens report in connection with this warranty?
5. The Haynesworth Corporation is sued for \$10 million in Year One. At the end of Year One, company officials believe a loss is only remote. However, the case drags on so that by the end of Year Two, company officials believe it is reasonably possible that a loss of \$2 million could be incurred. The case goes to trial during Year Three, and company officials now believe that a loss of \$3 million is probable. The case ends on April 23, Year Four, when the Haynesworth Corporation agrees to pay \$2.6 million in cash to settle all claims.

Indicate the amount of loss that will be reported by the Haynesworth Corporation in each of these four years.

6. On January 1, Year One, the Atlanta Company sues the Seattle Company for \$100 million for patent infringement. The case is expected to take years to settle. For each of the following independent situations, indicate the financial reporting to be made by each company.
 - a. Both companies believe that Atlanta will probably win this case. However, both feel that estimating the amount of this loss is virtually impossible.
 - b. Both companies believe that Atlanta will probably win this case. Both feel that Atlanta will probably win approximately \$9 million, but a win as high as \$46 million is reasonably possible.
 - c. Both companies believe that a loss by Seattle of \$53 million is reasonably possible.
 - d. Atlanta officials believe that their company will probably win \$44 million whereas Seattle officials believe that their company will probably lose \$8 million.

7. Ingalls Company is a jeweler located in a shopping mall in a midsize city in Ohio. During December of Year One, an unfortunate accident occurs. Mrs. Rita Yeargin trips over a giant, singing Rudolph set up by the mall management and goes sprawling into Ingalls's store where she cracked her head on a display case. She spent several days in the hospital with a sprained ankle, severely bruised elbow, and a concussion. Prior to the end of the year, Mrs. Yeargin's lawyer files papers to sue both the mall management company and Ingalls for \$1,000,000. Ingalls's insurance company informs the jeweler that the store policy does not cover accidents involving giant, singing Rudolphins. Ingalls's attorney is unsure as to what a jury might do in this case because of the unusual nature of the event. He estimates that a loss of \$800,000 is probable but that Ingalls will only be liable for 20 percent of that amount since the Rudolph actually belonged to the mall.
 - a. Determine if Ingalls needs to record a journal entry on December 31, Year One, and if so, prepare that entry.
 - b. Ingalls pays Mrs. Yeargin \$97,000 on July 11, Year Two, to settle this claim. Make the journal entry for Ingalls at that time.

8. Sadler Corporation produces lawnmowers. The lawnmowers are sold with a free three-year warranty. During Year One, Sadler sold 20,000 lawnmowers for \$10 million in cash. These lawnmowers cost \$5,800,000. Sadler's accountant estimates that 10 percent of the units will need to be repaired at some point over the next three years at an average cost of \$37 per lawnmower.
 - a. Make the journal entry to record the sale of the lawnmowers in Year One if a perpetual inventory system is used.
 - b. Make the journal entry (if any is needed) to record the warranty.
 - c. During Year Two, Sadler spends \$24,000 to repair a number of these lawnmowers. Prepare the necessary journal entry.
 - d. At the end of Year Two, Sadler's accountant reevaluates the warranty. The accountant suspects that the actual warranty liability will be higher than her original estimate. She now believes that 12 percent of the original sales will eventually result in a repair (but still at \$37 each). Make the necessary adjusting entry.

9. The Eyes Have It sells custom eyewear during Year One that come with an embedded warranty. If the glasses break during Year Two, they will be fixed for free. Customers may also purchase an extended warranty that covers Year Three. During Year One, the company sold 55,000 pairs of eyeglasses for \$1,000,000. Customers who purchased 40,000 of those pairs also purchased the Year Three extended warranty. The extended warranty brought in additional cash of \$200,000. The company expects that 6 percent of the glasses will break during Year Two, and another 8 percent will break during Year Three. Each repair will cost \$20 to fix.
 - a. Record the embedded warranty in Year One.
 - b. Record the sale of the extended warranties in Year One.
 - c. Assume that during Year Two the company spends \$70,000 to repair glasses for these customers. Prepare the necessary journal entry.
 - d. Assume that during Year Three the company spends another \$102,000 to repair glasses that are covered under the extended warranty. Prepare the necessary journal entry.

10. During Year One, Company A and Company Z both sell 1,000 computers for \$1,000 each in cash. Company A provides a one-year warranty to its customers for free. Company Z sells a one-year warranty to all of its customers for \$50 each. Both companies expect 5 percent of the computers to break and cost \$600 each to repair. In Year Two, both companies actually have 6 percent of these computers break. However, the required cost to fix each one was only \$550.
- In financial reporting for Year One, which company will report the highest amount of net income? What will be the difference in the two reported amounts?
 - In financial reporting for Year Two, which company will report the highest amount of net income? What will be the difference in the two reported amounts?
11. In several past chapters, we have met Heather Miller, who started her own business, Sew Cool. The following are the financial statements for December. To calculate age of accounts payable, assume that beginning inventory on 6/1/20X8, when Sew Cool started business, was zero. Also, assume that Sew Cool was only in business for 210 days.

Figure 13.23

Sew Cool Financial Statements

Sew Cool Income Statement As of December 31, 20X8	
Revenue	\$4,000
Cost of Goods	(2,000)
Gross Profit	2,000
Other Expenses	(1,695)
Earnings before Tax	305
Tax Expense	(107)
Net Income	\$198

Figure 13.24

Sew Cool Stmt. of Retained Earnings As of December 31, 20X8	
Retained Earnings, December 1, 20X8	\$500
Net Income	198
Dividends	<u>(158)</u>
Retained Earnings, December 31, 20X8	<u>\$540</u>

Figure 13.25

Sew Cool Balance Sheet December 31, 20X8			
Assets		Liabilities	
Current		Current	
Cash	\$940	Accounts Payable	\$900
Accounts Receivable	500	Income Tax Payable	<u>120</u>
Less Allowance for Doubtful Accounts	<u>(20)</u>	Total Current Liabilities	<u>\$1,020</u>
Net Accounts Receivable	480		
Inventory	<u>700</u>		
Total Current Assets	\$2,120		
Noncurrent		Noncurrent	
Equipment	\$1,000	Notes Payable	\$1,060
		Owners' Equity	
		Capital Stock	\$500
		Retained Earnings	<u>540</u>
		Total Owners' Equity	<u>\$1,040</u>
Total Assets	\$3,120	Total Liabilities & Owners' Equity	\$3,120

Based on the financial statements determine the following:

- a. Current ratio
- b. Age of accounts payable

COMPREHENSIVE PROBLEM

This problem will carry through several chapters, building in difficulty. It allows students to continually practice skills and knowledge learned in previous chapters.

In Chapter 12 "In a Set of Financial Statements, What Information Is Conveyed about Equity Investments?", financial statements for December were prepared for Webworks. They are included here as a starting point for the required recording for January.

Figure 13.26
Webworks Financial Statements

Webworks Income Statement As of December 31	
Revenue	\$16,950
Cost of Goods Sold	(8,657)
Gross Profit	<u>8,293</u>
Deprec. and Amort. Expense	(363)
Other Expenses and Losses	(3,790)
Investment Income	<u>100</u>
Earnings before Tax	4,240
Tax Expense	(1,272)
Net Income	<u>\$ 2,968</u>

Figure 13.27

Webworks Stmt. of Retained Earnings As of December 31	
Retained Earnings, December 1	\$9,322
Net Income	<u>2,968</u>
Retained Earnings, December 31	<u>\$12,290</u>

Figure 13.28

Webworks Balance Sheet December 31			
Assets		Liabilities	
Current		Current	
Cash	\$ 3,215	Accounts Payable	\$ 1,925
Accounts Receivable	2,250	Salaries Payable	200
Less Allowance for Doubtful Accounts	(225)		
Net Accounts Receivable	2,025		
Trading Securities, Net	360		
Merchandise Inventory	1,682		
Supplies Inventory	60		
Total Current Assets	\$ 7,342	Total Current Liabilities	\$ 2,125
Property, Plant, and Equipment			
Equipment	\$ 7,000		
Less Accumulated Depreciation	(876)		
Furniture	1,000		
Less Accumulated Depreciation	(51)		
Total P, P, and E	\$ 7,073		
Other Noncurrent Assets			
Licensing Agreement, Net	\$ 2,000		
		Owners' Equity	
		Capital Stock	\$2,000
		Retained Earnings	12,290
		Total Owners' Equity	\$14,290
		Total Liabilities & Owners' Equity	\$16,415
Total Assets	\$16,415		

The following events occur during January:

- a. Webworks starts and completes seven more sites and bills clients for \$4,500.
- b. Webworks purchases supplies worth \$100 on account.
- c. At the beginning of January, Webworks had fourteen keyboards costing \$113 each and twenty flash drives that had been written down to \$5 each in December due to obsolescence. Webworks uses periodic FIFO to cost its inventory.
- d. On account, Webworks purchases sixty-five keyboards for \$117 each and ninety of the new flash drives for \$20 each.
- e. Webworks pays Nancy Po (company employee) \$775 for her work during the first three weeks of January.
- f. Webworks writes off an account receivable from October in the amount of \$150 because collection appears unlikely.
- g. Webworks receives \$450 in advance to design a Web site for a local salon. Work will not begin on the Web site until February.
- h. Webworks sells sixty keyboards for \$9,000, all twenty of the old flash drives for \$100 and eighty of the new flash drives for \$2,400 cash.

- i. During January, Webworks receives notice that one of its former clients is not happy with the work performed. When Webworks refuses to refund the client's money, the client decides to sue for what he paid plus damages for his "pain and suffering," which comes to \$5,000. An attorney friend of Leon Jackson's (the owner of the business) mother believes that the suit is without merit and that Webworks probably will not have to pay anything.
- j. Webworks collects \$5,000 in accounts receivable.
- k. During January, Webworks sells all of its stock in XYZ Company for \$8 per share. Webworks had originally purchased sixty shares for \$5 and they were selling for \$6 per share on the last balance sheet date.
- l. Webworks pays \$200 for advertising that will run over the next two months.
- m. Webworks pays off its salaries payable from December.
- n. Webworks purchased 175 shares of QRS Company for \$10 per share. Webworks considers this an available-for-sale security.
- o. Webworks pays off \$9,000 of its accounts payable.
- p. Webworks pays Leon Jackson a salary of \$2,000.
- q. Webworks prepays \$600 for rent for the months of January, February, and March.
- r. QRS Company pays Webworks a dividend of \$30.

- s. Webworks pays taxes of \$1,000 in cash.

Required:

- a. Prepare journal entries for the previous events.
- b. Post the journal entries to T-accounts.
- c. Prepare an unadjusted trial balance for Webworks for January.
- d. Prepare adjusting entries for the following and post them to your T-accounts.

- t. Webworks owes Nancy Po \$200 for her work during the last week of January.
- u. Leon's parents let him know that Webworks owes \$320 toward the electricity bill. Webworks will pay them in February.
- v. Webworks determines that it has \$40 worth of supplies remaining at the end of January.
- w. Prepaid rent should be adjusted for January's portion.
- x. Prepaid advertising should be adjusted for January's portion.
- y. Webworks is continuing to accrue bad debts at 10 percent of accounts receivable.

- z. Webworks continues to depreciate its equipment over four years and its furniture over five years, using the straight-line method.
- aa. The license agreement should be amortized over its one-year life.
- ab. QRS Company is selling for \$9 per share on January 31.

- ac. Record cost of goods sold.

- e. Prepare an adjusted trial balance.
- f. Prepare financial statements for January.

RESEARCH ASSIGNMENT

Assume that you take a job as a summer employee for an investment advisory service. One of the partners for that firm is currently looking at the possibility of investing in **Barnes & Noble**. The partner is aware that **Barnes & Noble** sells a lot of gift cards. The partner is curious as to the size of the changes in that liability balance because the partner feels that increases and decreases will signal similar changes in revenue balances for the following year. The partner is also interested in knowing how much profit **Barnes & Noble** makes from breakage (gift cards that are never redeemed). The partner asks you to look at the 2011 financial statements for **Barnes & Noble** by following this path:

- Go to <http://www.barnesandnoble.com>.
 - At the very bottom of this screen, click on “Investor Relations.”
 - On the next screen, scroll to the bottom and click on “Annual Reports.”
 - On the next screen, in the center, click on “2011 Annual Report” to download.
 - Go to page 38 and read the paragraph under “Gift Cards.”
- a. What was the amount of gift card liability at the end of the previous year and at the end of the current year? What was the percentage change?
 - b. What was the amount of net income reported for the most recent year as a result of breakage (gift cards that were not redeemed)?