

**Solution Manual for Intermediate Accounting Vol 2 Canadian 2nd Edition Lo Fisher 0132965879 9780132965873**

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Chapter 11

Current Liabilities and Contingencies

**Chapter 11**  
**Current Liabilities and Contingencies**

**M. Problems**

**P11-1. Suggested solution:**

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

13. Income taxes payable	N	Obligation is not contractual in nature
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**P11-2. Suggested solution:**

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

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

- \* Present obligation: The debtor is presently contractually obliged to pay for goods or services received.
- \* Past event: The trade payable arose from a good or service the debtor previously received or consumed.

- \* Outflow of economic benefits: Trade payables are typically settled in cash—an outflow of economic benefits.

**P11-3. Suggested solution:**

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

**P11-4. Suggested solution:**

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

**P11-5. Suggested solution:**

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

			expected redemption date. If less than one year after the balance sheet date, the obligation is classified as current
14.	Income taxes payable	C	
15.	Bank loan that matures in five years that is currently in default	C	
16.	Three-year bank loan that matures six months after the balance sheet date	C	

**P11-6. Suggested solution:**

<b>Summary journal entries</b>			
	Dr. HST recoverable ( $\$10,000 \times 12\%$ )	1,200	
	Cr. Accounts payable ( $\$10,000 + \$1,200$ )		11,200
2.	Dr. Equipment ( $\$20,000 + \$500$ )	20,500	
	Dr. HST recoverable ( $\$20,500 \times 12\%$ )	2,460	
	Cr. Accounts payable ( $\$20,500 + \$2,460$ )		22,960
3.	Dr. Cash [ $\$15,000 \times (1 + 12\%)$ ]	16,800	
	Cr. Sales		15,000
	Cr. HST payable ( $\$15,000 \times 12\%$ )		1,800
	Dr. Cost of goods sold ( $\$15,000 \times 50\%$ )	7,500	
	Cr. Inventory		7,500
4.	Dr. Accounts receivable [ $\$20,000 \times (1 + 12\%)$ ]	22,400	
	Cr. Sales		20,000
	Cr. HST payable ( $\$20,000 \times 12\%$ )		2,400
	Dr. Cost of goods sold ( $\$20,000 \times 50\%$ )	10,000	
	Cr. Inventory		10,000
5.	Dr. Accounts payable	22,960	
	Cr. Cash		22,960
6.	Dr. HST payable ( $\$12,000 + \$1,800 + \$2,400$ )	16,200	
	Cr. HST recoverable ( $\$8,000 + \$1,200 + \$2,460$ )		11,660
	Cr. Cash ( $\$16,200 - \$11,660$ )		4,540

**P11-7. Suggested solution:**

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

**P11-8. Suggested solution:**

<b>Summary journal entries</b>		
Dr. GST recoverable ( $\$40,000 \times 5\%$ )	2,000	
Cr. Accounts payable [ $\$40,000 \times (1 + 5\%)$ ]		42,000
The purchase of inventory for resale is PST exempt.		
2. Dr. Cash [ $\$30,000 \times (1 + 5\%) \times (1 + 10\%)$ ]	34,650	
Cr. Sales		30,000
Cr. GST payable ( $\$30,000 \times 5\%$ )		1,500
Cr. PST payable [ $\$30,000 \times (1 + 5\%) \times 10\%$ ]		3,150
Dr. Cost of goods sold ( $\$30,000 \times 2/3$ )	20,000	
Cr. Inventory		20,000
3. Dr. Accounts receivable [ $\$60,000 \times (1 + 5\%) \times (1 + 10\%)$ ]	69,300	
Cr. Sales		60,000
Cr. GST payable ( $\$60,000 \times 5\%$ )		3,000
Cr. PST payable [ $\$60,000 \times (1 + 5\%) \times 10\%$ ]		6,300
Dr. Cost of goods sold ( $\$60,000 \times 2/3$ )	40,000	
Cr. Inventory		40,000
4. Dr. GST payable ( $\$20,000 + \$1,500 + \$3,000$ )	24,500	
Dr. PST payable ( $\$22,000 + \$3,150 + \$6,300$ )	31,450	
Cr. GST recoverable ( $\$21,000 + \$2,000$ )		23,000
Cr. Cash ( $\$24,500 + \$31,450 - \$23,000$ )		32,950



**P11-9. Suggested solution:**

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

**P11-10. Suggested solution:**

Oct. 31, 2015	Dr. Retained earnings	30,000	
	Cr. Dividends payable on preferred shares (10,000 sh × \$1.00/sh × 2) + (5,000 sh × \$2.00/sh)		30,000
	The preferred shares B are non-cumulative in nature and as such are not entitled to dividends for 2014 as they were not declared.		
Nov. 30, 2015	Dr. Retained earnings	50,000	
	Cr. Dividends payable on common shares (100,000 sh × \$0.50 sh)		50,000
Dec. 1, 2015	Dr. Dividends payable on preferred shares	30,000	
	Cr. Cash		30,000
Jan. 2, 2016	Dr. Dividends payable on common shares	50,000	
	Cr. Cash		50,000

**P11-11. Suggested solution:**

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

**P11-12. Suggested solution:**

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

**P11-13. Suggested solution:**

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

**P11-14. Suggested solution:**

<b>a. Summary journal entries</b>				
		Cr. Deferred revenue		12,000
2014	Dr. Cash (2 × \$3,000)		6,000	
	Dr. Deferred revenue (2 × \$2,000)		4,000	
	Cr. Revenue (2 × \$5,000)			10,000
	Dr. Cost of goods sold (2 × \$2,300)		4,600	
	Cr. Cash			4,600
2015	Dr. Cash (4 × \$3,000)		12,000	
	Dr. Deferred revenue (4 × \$2,000)		8,000	
	Cr. Revenue (4 × \$5,000)			20,000
	Dr. Cost of goods sold (4 × \$2,300)		9,200	
	Cr. Cash			9,200
<b>b. The balance in the deferred revenue account as at December 31, 2014 was \$8,000 (\$12,000 –</b>				

**P11-15. Suggested solution:**

1.

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

2.

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

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

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

**P11-16. Suggested solution:**

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

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

**P11-17. Suggested solution:**

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

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

**P11-18. Suggested solution:**

- Revenue is recognized for the award portion of company-offered rewards when the customer claims their reward. Revenue is recognized for the award portion of third-party rewards at the time of sale.
- The awards portion is determined using fair value techniques. Sales revenue is a residual amount equal to the price charged less that allocated to awards revenue.

**P11-19. Suggested solution:**

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

**P11-20. Suggested solution:**

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

**P11-21. Suggested solution:**

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

**P11-22. Suggested solution:**

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



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

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

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

**P11-23. Suggested solution:**

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

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

**P11-24. Suggested solution:**

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

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

**P11-25. Suggested solution:**

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

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

**P11-26. Suggested solution:**

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

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

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

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

**P11-27. Suggested solution:**

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

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

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

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

**P11-28. Suggested solution:**

<b>To recognize the provision in 2013</b>		
a. Dr. Warranty expense	240,000	
Cr. Provision for warranty payable		240,000
[\$4,800,000 × (1% + 2% + 2%)]		
<b>To recognize partial satisfaction of the warranty obligation in 2013</b>		
Dr. Provision for warranty payable	240,000	
Cr. Parts inventory		150,000
Cr. Wage expense		90,000
<b>To recognize the provision in 2014</b>		
Dr. Warranty expense	378,000	
Cr. Provision for warranty payable		378,000
(\$5,400,000 × 7%)		
<b>To recognize partial satisfaction of the warranty obligation in 2014</b>		
Dr. Provision for warranty payable	300,000	
Cr. Parts inventory		180,000
Cr. Wage expense		120,000

b. The balance in the warranty payable account as at December 31, 2014 was \$338,000 as set out in the T-account that follows:

<b>Provision for Warranty Payable</b>		
		260,000 Balance Dec. 31, 2012
		240,000 Provision 2013
Claims 2013	240,000	
		378,000 Provision 2014
Claims 2014	300,000	
		<u>338,000</u> Balance Dec. 31, 2014

**P11-29. Suggested solution:**

<b>Summary journal entries</b>		
<b>To recognize the flight-related revenue in 2015</b>		
a. Dr. Cash	8,000,000	
Cr. Flight revenue		7,910,000
Cr. Unearned revenue (award points)		90,000
<b>To recognize reward point revenue in 2016</b>		
b. Dr. Unearned revenue (award points)	36,000	
Cr. Award revenue		36,000
<b>To recognize reward point revenue in 2017</b>		
b. Dr. Unearned revenue (award points)	45,000	
Cr. Award revenue		45,000
<b>Supporting computations and notes</b>		
<p>- 6,000,000 miles are expected to be redeemed (<math>8,000,000 \times 75\% = 6,000,000</math>). This translates into 500 flights (<math>6,000,000 / [(15,000 + 25,000) / 2] = 300</math>).</p> <p>- To obtain the amount of reward revenue to recognize, the denominator is the number of miles expected to be redeemed rather than the number awarded. (<math>\\$90,000 / 300 \text{ flights} = \\$300</math>), which is the fair value of each flight expected to be awarded.</p> <p>- 120 reward flights are redeemed in 2016. (<math>120 / 300 \times \\$90,000 = \\$36,000</math>).</p> <p>- 150 reward flights are redeemed in 2017. (<math>150 / 300 \times \\$90,000 = \\$45,000</math>).</p>		

**P11-30. Suggested solution:**

<b>Summary journal entries</b>		
<b>To recognize the sales-related revenue in 2014</b>		
a. Dr. Cash	15,000,000	
Cr. Sales		14,895,000
Cr. Unearned revenue (premiums)		105,000
Dr. Cost of goods sold [14,895,000 / (1 + 50%)]	9,930,000	
Cr. Inventory		9,930,000
<b>To recognize premium revenue in 2015</b>		
b. Dr. Unearned revenue (premiums)	30,000	
Cr. Sales		30,000
Dr. Cost of goods sold [30,000 / (1 + 50%)]	20,000	
Cr. Inventory		20,000
<b>To recognize premium revenue in 2016</b>		
b. Dr. Unearned revenue (premiums)	45,000	
Cr. Sales		45,000
Dr. Cost of goods sold [45,000 / (1 + 50%)]	30,000	
Cr. Inventory		30,000
<b>Supporting computations and notes</b>		
<p>- 10,500,000 point are expected to be redeemed (<math>15,000,000 \times 70\% = 10,500,000</math>); <math>10,500,000</math> points / <math>1,000 = 10,500</math> gift cards; <math>10,500 \times \\$10 = \\$105,000</math> fair value to customer of premiums.</p> <p>- 3,000,000 points are redeemed in 2016. (<math>3,000,000 / 1,000 \times \\$10 = \\$30,000</math>).</p> <p>- 4,500,000 points are redeemed in 2017. (<math>4,500,000 / 1,000 \times \\$10 = \\$45,000</math>).</p>		

c. Companies offer incentive programs to increase sales.

**P11-31. Suggested solution:**

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

c. The cash basis cannot normally be used to account for warranty expenses as it does not properly match expenses to revenues. In the example above, 2014's profitability is overstated \$230,000 (\$400,000 – \$170,000) when the cash basis is used.

d. If management's provision subsequently proves to be incorrect, the change in estimate is adjusted for prospectively in the manner discussed in Chapter 3. Essentially Stanger will debit warranty expense for an additional \$70,000 in 2015 when the new information (claims in excess of the provision) becomes known. Stanger is not required to restate 2014's results as this is a change in estimate, rather than an error.



**P11-32. Suggested solution:**

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

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

\* 6 months earned / 12 month contract = 50%; 6 month / 24 month contract = 25%; 6 month / 36 month contract = 16 $\frac{2}{3}$ %

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

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

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

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

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

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

**P11-33. Suggested solution:**

a.

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

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

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

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

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

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

Jul. 2016	5	18	12	6	\$ 1,800	\$ 900
Aug. 2016	5	19	12	7	\$ 1,800	\$ 1,050
Sep. 2016	5	20	12	8	\$ 1,800	\$ 1,200
Oct. 2016	5	21	12	9	\$ 1,800	\$ 1,350
Nov. 2016	5	22	12	10	\$ 1,800	\$ 1,500
Dec. 2016	5	23	12	11	\$ 1,800	\$ 1,650
Jan. 2017	10	24	12	12	<u>\$ 3,600</u>	<u>\$ 3,600</u>
					\$ 35,100	<u>\$ 13,500</u>

The current portion of the obligation is  $\$117,150 - \$13,500 = \$103,650$

**P11-34. Suggested solution:****Summary journal entries**

a.	Dr. Cash	10,000,000	
	Cr. Flight revenue		9,925,000
	Cr. Unearned revenue (award points)		75,000
<b>To recognize reward point revenue in 2015</b>			
b.	Dr. Cash	20,000	
	Dr. Unearned revenue (award points)	30,000	
	Cr. Award revenue		30,000
	Cr. Flight revenue		20,000
<b>To recognize reward point revenue in 2016</b>			
b.	Dr. Cash	15,000	
	Dr. Unearned revenue (award points)	22,500	
	Cr. Award revenue		22,500
	Cr. Flight revenue		15,000

**Supporting computations and notes**

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

- 200 reward flights are redeemed in 2015. ( $200 / 500 \times \$75,000 = \$30,000$ ). A \$100 service charge is levied for each award flight. ( $200 \times \$100 = \$20,000$ )

- 150 reward flights are redeemed in 2016. ( $150 / 500 \times \$75,000 = \$22,500$ ). A \$100 service charge is levied for each award flight. ( $150 \times \$100 = \$15,000$ )

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

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

c. Management expects to award a total of 500 flights. On December 31, 2016, 150 flights remain to be taken [500 flights – 200 (flights taken in 2015) – 150 (flights taken in 2016)]. As these 150 flights are expected to be taken evenly during 2017–2019, this means it is anticipated that 50 flights will be taken each year ( $150 / 3 = 50$ ).

The current liability to be reported for unearned award miles revenue on December 31, 2016 is  $\$7,500$  ( $50 \times \$150 = \$7,500$ ).

**P11-35. Suggested solution:**

**To provide for the expected liability settlement**

Dr. Lawsuit settlement expense	8,400,000	
Cr. Provision for liability settlement costs		8,400,000
[ $(\$8,000,000 \times 80\%) + (\$10,000,000 \times 20\%) = \$8,400,000$ ]		

**To allocate a portion of the ticket sales proceeds to the award program**

Dr. Flight revenue	720,000	
Cr. Unearned revenue (award miles)		720,000

As the award portion of the flights has not previously been allowed for, an entry is required to reverse a portion of the ticket sales revenue from flight revenue to award revenue

**To recognize award point revenue in 2016**

Dr. Unearned revenue (award miles)	144,000	
Cr. Award revenue		144,000
( $30,000,000 \times 80\% = 24,000,000$ ) miles expected to be redeemed. ( $4,800,000 / 24,000,000 \times \$720,000 = \$144,000$ )		

**P11-36. Suggested solution:**

- a. A contingent liability is either i) a present obligation, the amount of which cannot be measured with sufficient reliability; or ii) a possible obligation. Possible obligations are amounts that may be owed depending on the outcome of future event(s). A contingent asset is a possible asset. Possible assets are amounts that may be due depending on the outcome of future event(s).
- b. There are two factors that govern accounting for contingent liabilities: i) the likelihood of the outcome and ii) the measurability of the obligation. If the outcome is probable and the obligation is measurable, the entity provides for the obligation using expected value techniques. “Probable” is defined as likelihood greater than 50%. If the outcome is probable, but the obligation cannot be reliably measured, or the outcome is only possible, then the entity does not provide for a liability. Rather, the entity discloses the details of

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

**P11-37. Suggested solution:**

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

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

**Contingent liabilities:**

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

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

**Contingent assets:**

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

**P11-38. Suggested solution:**

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

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

2. (B) The outcome is possible but not probable, so note disclosure is required.

3. (A) A \$1,000,000 liability is provided for as the loss is probable and can be reliably measured. While the final settlement may be as low as \$5 million or as high as \$10 million, Canless is responsible only for the \$1,000,000 deductible.

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

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

Dr. Contract settlement expense	770,000	
Cr. Provision for contract settlement costs		770,000
$\{[(\$1,000,000 + \$1,200,000) / 2] \times 70\% \} + (\$0 \times 30\%) = \$770,000$		

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

Dr. Lawsuit settlement expense	180,000	
Cr. Provision for liability settlement costs		180,000
$(\$200,000 \times 90\%) + (\$0 \times 10\%) = \$180,000$		

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

**P11-39. Suggested solution:**

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

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

**P11-40. Suggested solution:**

a. Assuming that the reporting company prepares its financial statements in accordance with IFRS

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

Dr. Contract settlement expense	385,000	
Cr. Provision for contract settlement costs		385,000
$\{[(\$600,000 + \$800,000) / 2] \times 55\% \} + (\$0 \times 45\%) = \$385,000$		

2. (A) The loss is probable and so the company must make a provision. Expected value techniques should be used to determine the amount of the obligation based on legal counsel's best estimate of the amount required to settle the obligation. If Morton subsequently accepts the \$200,000 offer, this is a change in estimate that will be dealt with prospectively.

Dr. Lawsuit settlement expense	187,500	
Cr. Provision for liability settlement costs		187,500
$\{[(\$200,000 + \$300,000) / 2] \times 75\% \} + (\$0 \times 25\%) = \$187,500$		

b. Assuming that the reporting company prepares its financial statements in accordance with ASPE

1. (B) The probability of loss is 55% which is less than the 70% threshold commonly used in ASPE to determine whether payout is likely. Note disclosure is required.

2. (A) The loss is likely and so the company must recognize a contingent loss for the minimum in the range and disclose the remainder in the notes to the financial statements.

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



**P11-41. Suggested solution:**

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

**P11-42. Suggested solution:**

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

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

**P11-43. Suggested solution:**

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

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

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

**P11-44. Suggested solution:**

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

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

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

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

**P11-45. Suggested solution:**

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

2.

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

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

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

4. The loss is probable and has to be provided for. Expected value techniques may be used to determine the amount of the obligation.

Dr. Loss on lawsuit (breach of contract)	93,000
Cr. Provision for lawsuit settlement costs	93,000
[( $\$100,000 \times 50\%$ ) + ( $\$90,000 \times 30\%$ ) + ( $\$80,000 \times 20\%$ ) = \$93,000]	

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

**P11-46. Suggested solution:**

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

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

2. A journal entry is not required. The solvent is a relatively low cost component of the chromatography process. While the market price is now much lower than the price previously contracted for, it is inferred that the expected benefits to Regina still exceed the unavoidable costs. Accordingly, the contract is non-onerous and does not need to be provided for in Regina's financial statements.

3. A journal entry is not required. The loan may be reported as a non-current liability as the grace period extends 12 months after the balance sheet date.

4. The loss is probable and has to be provided for. Expected value techniques may be used to determine the amount of the obligation.

Dr. Loss on lawsuit (customer injury)	260,000	
Cr. Provision for lawsuit settlement costs		260,000
[( $\$300,000 \times 60\%$ ) + ( $\$200,000 \times 40\%$ ) = $\$260,000$ ]		

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

**P11-47. Suggested solution:**

1. A journal entry is not required as the outstanding amount of the liability has not changed. From a reporting perspective, the loan will be reported as a non-current obligation as the lender agreed to a 12-month grace period before year-end.

2. IFRS allows for short-term, zero-interest-rate notes to be measured at the original invoice amount if the effect of discounting is immaterial. This is the case here as the note is due in 30 days and the imputed interest amount is immaterial (about \$30).

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

3. While Port Mellon has contracted to pay more for the phosphorus than the year-end market price, it remains that the expected economic benefit exceeds the unavoidable costs. The contract is thus non-onerous and does not need to be provided for.

4. This is a third-party reward. As Gander is not an agent of the airline, revenue and expense pertaining to the award are separately recognized.

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

5.

Dec. 31, 2013	Dr. Interest expense	256	
	Cr. Accrued interest payable		256
	$\$20,000 \times 6\% \times 78 / 365 = \$256$ (rounded)		

## N. Mini-Cases

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

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

Memo to: Audit file

From: CA

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

#### **Going concern**

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

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

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

debt- to-equity ratio is 86%, while the bank is asking for a maximum debt-to -equity ratio of 80%. This ratio will require improvement in order to meet the covenants set out by the bank in its November 1 letter.

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

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

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

### **Accounting issues requiring resolution**

#### **Capital assets**

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

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

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

#### **Inventory transaction**

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

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

### **Secured operating line of credit**

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

### **Tax/GST liabilities**

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

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

Dear Mr. Donnelly:

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

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

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

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

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

Yours truly,

WB, Chartered Accountants

### Draft report to Earth Movers Ltd. (EML) on financing available from S&L Bank

#### **Basis of calculations: the financial statements**

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

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

#### **Working capital ratio**

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

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

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

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

#### **Accounting policies: underlying assumptions or adjustments**

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

##### *Accounts receivable*

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

*Amount owed to the previous auditor*

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

*Parts of scrapped earth movers held for resale—\$60,000*

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

*Spare parts inventory*

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

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

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

As noted earlier, EML and the bank must agree on definitions to be included in the agreement—for example, the definitions of such terms as “inventory” and “equipment.” Their definition affects the amount of financing available since the bank proposes to lend money at different percentages on these two categories (for instance, it will lend 30% of the value of inventory under Formula 1). In addition, inventory is a current asset and is therefore included in the calculation of the working capital ratio. Equipment, however, is a long-term asset, so it is excluded from the calculation of the working capital ratio.

*Capital assets*

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



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

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

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

#### *Landfill sites*

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

#### *Funds due to shareholder*

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

#### *Other*

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

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

#### **Calculation of financing available**

We have restated the balance sheet in accordance with the preceding analysis, as follows:

	As stated in unaudited balance sheet, June 30, 2014	Revised under the given assumptions
Cash	\$ 84,000	\$ 84,000
Accounts receivable	585,000	410,000
Non-current assets held for resale	0	60,000
Spare parts inventory	907,000	477,000
Land, building, and equipment	2,759,000	2,705,100

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

#### *Financing available*

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

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

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

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

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

#### **Sensitivity analysis**

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

1. If we include the amount of \$90,000 receivable from the insurance company, the amount of financing you can expect to receive will increase by \$63,000 ( $\$90,000 \times 70\%$ ) under Formula 1 and by \$72,000 ( $\$90,000 \times 80\%$ ) under Formula 2. Under neither formula will the amount received from the bank cover the amount owed to you.

2. If the Banbury landfill site is included in the calculation, the loan would increase by \$145,000 ( $\$290,000 \times 50\%$ ) or \$203,000 ( $\$290,000 \times 70\%$ ). This scenario is very unlikely to materialize. No provision for site restoration costs has been made for this site, and the bank would probably question the value assigned to the site.

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

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

1. The liability to the vendor will be recorded at \$17,589, determined as set out below. The accrued interest of \$682 will be reported as a current liability, while the principal portion of \$16,907 will be reported as long-term debt.

Present value of the note at origination using a BAII PLUS financial calculator: 3 N; 8 I/Y; 20000 FV; 400\* PMT; CPT PV PV = -16,907 rounded. The computer asset will be recorded at \$16,907.

\*\$20,000 × 2% = \$400

Accrued interest to December 31, 2013 = \$16,907 × 8% × 184 / 365 = \$682

(rounded) The liability to be recorded = \$16,907 + \$682 = \$17,589.

2. The key word in the facts given in the question is “possible.” As legal counsel advises that the outcome is possible, rather than probable, a liability is not provided for. Rather, the nature and details of the lawsuit should be disclosed in the notes to the financial statements. Had counsel determined the outcome to be probable, an obligation would be provided for using present value techniques.

3. IAS 39 paragraph 43 requires that the guarantee be initially reported at its fair value. The fair value considers the amount of the guarantee, the prevailing discount (interest) rate, and the probability of default. Subsequently the guarantee is measured at the higher of the best estimate to settle and the remaining provision recorded in the financial statements. IFRS 7 requires that LISL disclose the nature of the guarantee including the maximum risk exposure (\$100,000).

4. Because LISL was granted the waiver before year-end, the term loan with the bank may be reported as a non-current liability. Had the waiver been received after year-end but before the statements are issued, the liability must be presented as a current obligation with the details of the grace period disclosed.

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

To: Mr. Robert Watt, CEO

From: Ranjit Sidhu, CFO

Date: February 15, 2013

Re: Contemplated changes to the company's warranty and reward programs

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

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

The full price of the warranty will be recognized as revenue in the year of the sale. These revenues will be partially offset by the expected cost of servicing the warranty during the coverage period; however this provision will be lower than before as it no longer includes unearned profits.

We currently sell warranties covering about 70% of our products. In a bundled sale, this will increase to 100%. Assuming that our sales levels of appliances remain unchanged—which, as discussed below, is by no means certain—then revenues and profit will increase incrementally from the (bundled) sale of the additional warranties.

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

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

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

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

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

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

## CHAPTER 11

### Current liabilities and contingencies

#### LEARNING OBJECTIVES

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

#### OVERALL APPROACH

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

#### KEY POINTS

*Overview of liabilities:* Section B (Pages 506-508) discusses the definition, recognition, classification, and measurement of liabilities. Here, classification precedes measurement because the method of measurement depends on the classification of the particular liability.

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

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

It is necessary to distinguish financial from non-financial liabilities because the measurement bases differ. Financial liabilities are a type of financial instrument, so the standards for financial instruments are important for these liabilities.

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

The measurement of liabilities depends on their classification.

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

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

1. Trade payables should be familiar to students. Two issues require further discussion:
  - a. The difference between the gross and net methods of recording cash discounts. Although the net method is more conceptually sound, the gross method is more commonly used. Businesses can justify using the gross method based on the cost-benefit and materiality constraints. Some students may recall that the mirror image of this issue was covered in Chapter 5 on accounts receivable. Also similar to accounts receivable is the fact that trade payables are not usually discounted for the time value of money due to the relatively high volume of transactions and the low amount of interest that would be imputed.
  - b. The concept of “cut off”. Cut off refers to ensuring that all obligations entered into during a reporting period are properly recognized in the correct period. Cut off is an important concept and is pervasive across all elements of the financial statements. Incorrect cut off can cause errors or omissions in reporting. Some examples are:
    - Sales invoices recognized at year end but goods do not ship until the beginning of the next fiscal period. This will overstate sales and accounts receivable.
    - Failure to accrue expenses in the current period that have been incurred but not yet paid. This will understate expenses and accounts payable.
    - Failure to record purchases for goods received. This will understate accounts payable and inventory.

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

- a. Sales tax liabilities are classified as non-financial liabilities because they are legislated and not contractual. There is a risk that discussion here can become complicated because of the diversity of sales tax regimes in different provinces, and the technical details of the tax rules. It is therefore important to focus on the *accounting* for these taxes, not the specific tax rules. The important point to note is that an enterprise merely acts as an agent of the government, so that any taxes charged on sales made to customers are the property of the government and payable to it. On the purchases side, GST/HST paid on inputs are refundable to the enterprise and are therefore recorded as GST/HST recoverable. In contrast, PST paid is generally not recoverable. (PST is not payable on goods purchased for resale, while PST on goods not for resale becomes part of the cost of the items.) Page 512 discusses some of the complexities that can arise when accounting for sales taxes.
- b. Income taxes payable are classified as non-financial liabilities also. Income taxes will be covered in more detail in Chapter 16.
- c. Dividends payable occur when *cash* dividends are *declared* but not yet paid. The payable will normally be classified as current and the obligation only arises when dividends are declared, no amounts are accrued for cumulative preferred dividends in arrears. Stock dividends do not give rise to a liability and can be revoked by the board of directors before issuance.
- d. Royalty fees arise from contractual obligations in a franchise agreement; therefore, unpaid royalty fees owing represent a current liability.

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

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

5. Warranties can be either a part of a product, or sold separately. The latter was covered in Chapter 4 on revenue recognition, so the focus here is on the former (manufacturers’

warranties). Warranties are a type of contingency, which is discussed more thoroughly later in the chapter, because the outflow of resources depends on the outcome of future events (i.e., the product malfunctioning during the warranty period). Because the likelihood of loss is probable, and the amount can be reasonably estimated, IFRS treats warranty costs as a type of provision. The amount of the provision requires the use of expected value techniques (e.g., weighted average). Where the warranty obligations are deemed immaterial, the costs can be expensed as incurred.

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

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

- a. Customer loyalty programs give rise to deferred revenue. These loyalty programs involve the initial delivery of the primary product, plus a promise of future goods or services. Depending on who provides the future goods or services, the accounting differs. If a third party supplier is involved, then the reporting entity simply records an expense for the amount it needs to pay the third party for the loyalty points. If the reporting entity itself supplies the rewards, then it must treat the transaction as having multiple deliverables: those for the initial sale and those for the future delivery of rewards.
- b. Premiums are goods and services that can be purchased by customers by exchanging “points” earned from past purchases. Coupons entitle a customer to a discount off the retail price. Rebates require a customer to apply for a refund on a retail purchase. Premiums are accounted for similar to customer loyalty programs in that the initial sales represent a multiple deliverable. Measurement of the liability for the premium references the value to the customer, not the cost to the entity. Measurement of coupon and rebate liabilities is similar to the accounting for warranties. Where management’s initial estimates prove incorrect, changes to the estimates are treated prospectively.

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

Maturing and debt in default create some interesting reporting issues. Exhibit 11-16 on page 527 summarizes the treatments. The reporting outcomes depend on whether the enterprise obtains the renewal or grace period prior to (i) the year-end or (ii) the financial statement approval date.



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

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

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

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

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

## **USE OF END-OF-CHAPTER PROBLEMS AND CASES**

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

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

L.O. number	Learning objective	Pages	Suggestions for in-class discussion	Suggestions for assignments
11-1.	Describe the nature of liabilities and differentiate between financial and non-financial liabilities.	506-508	P11-2 P11-3	P11-5
11-2.	Describe the nature of current liabilities and account for common current liabilities including provisions.	509-527	P11-6 P11-18	P11-8 P11-15 P11-35
11-3.	Describe the nature of contingent assets and liabilities and account for these items.	527-534	P11-35	P11-38
11-4.	Describe the nature of commitments and guarantees and apply accrual accounting to them.	534-536	P11-45	P11-47
--	Integrative		Case 1 Cool Look Limited	Case 2 Earth Movers Ltd.

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

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



## Chapter 12

# Non-current Financial Liabilities



## LEARNING OBJECTIVES

- L.O. 12-1. Describe financial leverage and its impact on profitability.
- L.O. 12-2. Describe the categories and types of non-current liabilities.
- L.O. 12-3. Describe the initial and subsequent measurement of non-current financial liabilities and account for these obligations.



## LEARNING OBJECTIVES

- L.O. 12-4. Apply accrual accounting to the derecognition of financial liabilities.
- L.O. 12-5. Apply accrual accounting to decommissioning and site restoration obligations
- L.O. 12-6. Describe how non-current liabilities are presented and disclosed



## A. INTRODUCTION (L.O. 12-1)

### 1. Overview

- **Non-current liabilities** - obligations expected to be settled more than one year after the balance sheet date or normal operating cycle, whichever is longer.
- Borrowing comprises the major portion of non-current liabilities



## Why Companies Borrow to Acquire Assets

- They have insufficient cash to pay for the acquisition, or
- They expect to profit by investing in assets that generate income in excess of borrowing costs



## 2. Financial Leverage

- **Financial leverage** - quantifies the relationship between the relative level of a firm's debt and its equity base
- It is a measure of solvency
- Offers shareholders an opportunity to increase ROE but with increased exposure to risk
- Increased financial leverage amplifies the risk of bankruptcy
- **See Exhibit 12-1**





## CHECKPOINT CP12-1

What is the primary advantage of leverage and what are the two disadvantages of leverage?



### 3. Debt Rating Agencies

Independently:

- Evaluate strength of governments and companies that issue publicly traded debt and preferred shares
- Assess borrower's ability to pay debt when due
- The higher the rating, the lower the risk of default



## CHECKPOINT CP12-2

Why is it important to have debt-rating agencies?



## B. COMMON NON-CURRENT FINANCIAL LIABILITIES (L.O. 12-2)

- Can be financial or non-financial in nature
- Financial liabilities require delivery of cash or other financial assets to another party at a future date.
- Non-current financial liabilities include:
  - bonds, notes payable, bank loans, and leases
- Non-current, non-financial liabilities include:
  - decommissioning and site restoration costs, and deferred income taxes.



## 1. Notes Payable

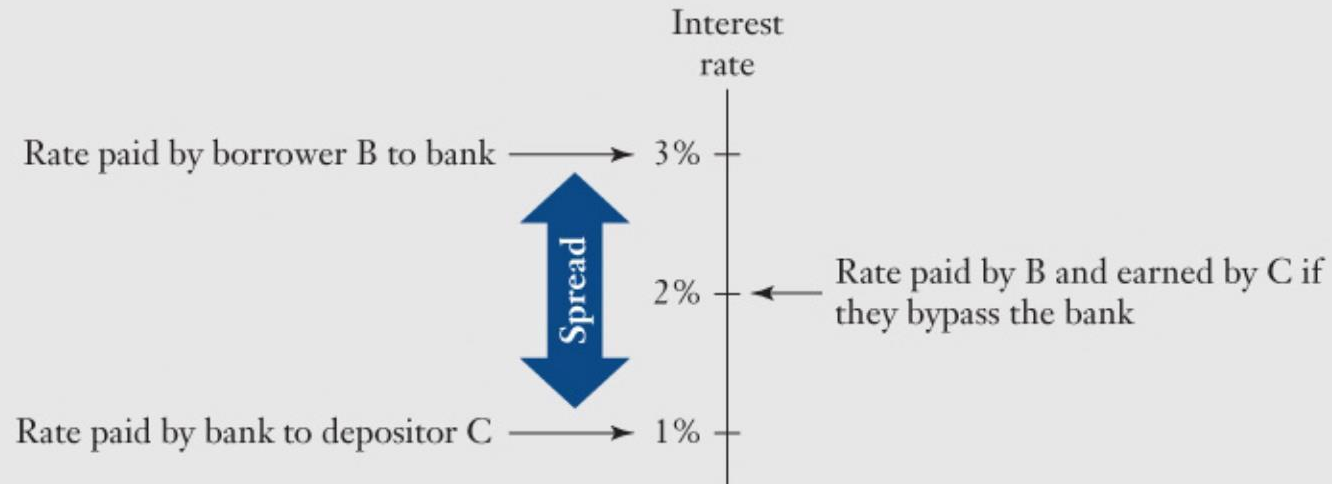
- Current/Non-current depends on time to maturity
- Can be traded on an exchange or over-the-counter
- Notes of privately owned firms not publicly traded
- Banks and financial institutions make money by charging a “spread”— the difference between rate charged on loans and rate paid on deposits
- Notes sold directly to investors reduces interest



## Reducing the spread

Exhibit 12-3

## Reducing the spread





## CHECKPOINT CP12-3

Why do companies sell notes directly to the investing public?



## 2. Bonds

### a. Overview

- A common form of long-term debt
- Includes **covenants** – restrictions on borrower's activities while bond is outstanding
- A **bond indenture** outlines bond's terms, such as:
  - maturity date
  - interest rate and payment dates
- Interest rate stated per annum, payments often semi-annually





## 2. Bonds

### Overview (continued)

- Selling bonds - reduces borrowing cost
  - increases capital amount accessed
- Bonds may be sold through:
  - private placement (rarely), or
  - Investment banks (mostly)
- Investment banks sell bonds for customers by
  - Firm commitment underwriting
  - Best efforts approach



## b. Types of Bonds

- **Secured bonds** – backed by specific collateral
- **Debentures** – Unsecured bonds
- **Stripped (zero coupon bonds)** – pay no interest
- **Serial bonds**- mature in blocks at a time
- **Callable bonds** – permit early issuer redemption
- **Convertible bonds** – by holder to another security
- **Inflation-linked or real-return bonds** – adjusts rate for inflation
- **Perpetual bonds** – never mature (bonds or equity?)



## C. INITIAL MEASUREMENT (L.O. 12-3)

- Record at fair value minus debt issue costs
- Issue costs: bank and regulatory fees,  
accounting, legal, promotional
- Fees for held-for-trading bonds are expensed
- In most cases fair value easy to determine
- Sometimes fair value more difficult to determine
- Determining issue price covered in 12-C.5 below



## CHECKPOINT CP12-4

A bond indenture includes covenants. What is a bond indenture and what are covenants?



## CHECKPOINT CP12-5

How are bonds traded subsequent to issue?  
How do the dealers earn a profit?



## 1. Debt Exchanged for non-cash Assets

- Notes and debt instruments exchanged for assets are recognized at fair value of assets acquired (IAS 16.6)
- Fair value determined based on the following in order of preference:
  - active market for debt
  - recent similar transactions
  - discounted cash flow analysis



## 2. Debt Issued at Non-Market Rates of Interest

- Fair value differs from face value when:
  - Note is non-interest bearing (use implicit rate)
  - Stated (coupon) rate differs from market rate (discount/premium results)
  - If note issued for non-cash, use fair value of consideration received
  - **See Exhibit 12-4**



### 3. Compound Financial Instruments

- **Compound financial instrument** – has both debt and equity features
- For example, a convertible bond; can be exchanged for common shares in issuing company
- Initial recognition – Separate issue price into debt and equity components (covered in Chapter 14)





## 4. Issuing Bonds at Par, a Premium, or a Discount

Understanding the terms used is important:

- **Coupon (or stated) rate** - interest rate specified in the bond indenture
- **Yield or market rate** - rate of return (on a bond) actually earned by the investor at a particular time
- **Effective interest rate** - yield on the date of issuance of a debt
- **Par value (face value)** - amount to be repaid to the investor at maturity



## Issuing Bonds at Par, a Premium, or a Discount (Continued)

- Bonds sell at a discount if coupon  $<$  market rate
- Bonds sell at par value when coupon = market rate
- Bonds sell at a premium if coupon  $>$  market rate
- Companies normally aim to issue the bonds at par by setting the coupon rate to equal the prevailing market rate of interest



## 5. Determining the Sales Price of a Bond When the Yield is Given

- Investors normally demand a certain bond yield
- When the yield is known, sales price of a bond is **the present value (PV) of future cash flows:**

**PV of coupons (periodic interest)**

**(coupon rate x par value)**

**xxx\***

**+ PV of face (par) value at maturity**

**xxx\***

**= *Sales Price of bonds on issue date***

**xxx**

- \* All cash flows are discounted at the **yield rate** on issue date.



## 6. Timing of Bond Issuance

### a. Selling bonds on the issue date specified in the indenture

Dr. Cash	XXX	
Cr. Bonds Payable		XXX

**Note:** The bonds payable account is always credited with the issue price. However, if there are bond issue costs, both Cash and Bonds Payable are reduced by those costs. (See Exhibit 12-7)



## Timing of Bond Issuance (continued)

- b. Selling bonds after the specified issue date**
- Purchaser pays agreed upon price plus accrued interest since last interest payment.
  - At interest payment date, interest is paid for the entire interest period (semi-annual or annual)
  - Premium or discount is amortized from the date of sale to maturity.



## Timing of Bond Issuance (continued)

### b. Selling bonds after the specified issue date (Journal entries)

Dr. Cash	xxx	
Cr. Bonds Payable		xxx
Cr. Bond Interest Payable		xxx
(or <i>Bond Interest Expense</i> )		

### On Interest Payment Date

Dr. Bond Interest Expense (since issue)	xxx	
Dr. Bond Interest Payable	xxx	
Cr. Cash		xxx

*If bond interest expense account had been credited initially*

Dr. Bond Interest Expense (full periodic)	xxx	
Cr. Cash		xxx



## Accounting for the issuance of bonds between interest payment dates

### Exhibit 12-8

### Accounting for the issuance of bonds between interest payment dates

On date of sale

Dr. Cash	1,010	
Cr. Bonds payable		1,000
Cr. Accrued interest on bond payable (balance sheet) <sup>9</sup>		10

On date of first interest payment

Dr. Accrued interest on bond payable	10	
Dr. Interest expense	20	
Cr. Cash		30

## D. SUBSEQUENT MEASUREMENT

- All financial liabilities (except those held for trading) are measured and reported at **amortized cost**
- Two steps to determine the amortized cost:
  1. establish the effective interest rate; and
  2. amortize the premium or discount using the effective interest method





## 1. Effective Interest Rate

- IFRS requires the effective interest method to determine amortized cost
- Effective interest rate = yield of the debt on the issuance date



## 2. Amortization Using the Effective Interest Method

a. Interest payment coincides with fiscal year-

end Three step Approach:

i. Calculate interest expense for the period

ii. Determine amount of discount or premium to be amortized

iii. Compute the new amortized cost of the outstanding liability

See Exhibit 12-9



# Amortization Using the Effective Interest Method (continued)

## (Discount Amortization Schedule)

(A) Period (Date)	(B) Interest Expense (Amortized Cost X Yield Rate)	(C) Cash Paid (Face Value x coupon rate)  (constant amount)	(D)  Discount Amortized  (B-C)	(G)  Amortized Cost  $AC(t-1) + D$
Issue Date				XXX



# Amortization Using the Effective Interest Method (continued)

## (Premium Amortization Schedule)

(A) Period (Date)	(B) Interest Expense (Amortized Cost X Yield Rate)	(C) Cash Paid (Face Value x coupon rate)  (constant amount)	(D)  Premium Amortized (C-B)	(G)  Amortized Cost  <b>AC(t-1) - D</b>
Issue Date				XXX



## Amortization of Bond Discount, Premium (continued)

- Amortizing bond discount **increases** annual interest expense relative to the coupon payments
- Amortizing bond premium **decreases** annual interest expense relative to the coupon payments
- At maturity the amortized cost equals the face value of the bond



## Interest Payment and Discount/Premium Amortization (continued)

### *In the case of a Discount:*

Dr. Bond Interest Expense	XXX	
Cr. Bonds Payable (discount amortized)		XXX
Cr. Cash		XXX

### *In the case of a Premium:*

Dr. Bond Interest Expense	XXX	
Dr. Bonds Payable (premium amortized)		XXX
Cr. Cash		XXX



b. When Interest Payments Do Not Coincide with  
fiscal Year-end

*In the case of a Discount:*

Dr. Bond Interest Expense (fractional period)	xxx	
Cr. Bonds Payable (fractional period amortization)		xxx
Cr. Bond Interest Payable (fractional period)		xxx

*In the case of a Premium:*

Dr. Bond Interest Expense (fractional period)	xxx	
Dr. Bonds Payable (fractional period amortization)		xxx
Cr. Bond Interest Payable		xxx



## Interest Payment, Discount/Premium Amortization after Year-end Accruals

### *Discount Situation*

Dr. Bond Interest Expense (since year-end)	xxx	
Dr. Bond Interest Payable (accrued at year-end)	xxx	
Cr. Bonds Payable (Disc amortized since year-end)		xxx
Cr. Cash (periodic amount)		xxx

### *Premium situation*

Dr. Bond Interest Expense (since year-end)	xxx	
Dr. Bonds Payable (Premium amortized since year-end)	xxx	
Dr. Bond Interest Payable (accrued at year-end)	xxx	
Cr. Cash (periodic amount)		xxx





### 3. Amortization Using the Straight-line Method

- No mandated amortization method under ASPE
- Implicit permission to use straight-line by PE
- Same amount of discount/premium amortized each period; therefore same net interest expense
- Method is simple, still widely used in Canada
- Results may not differ materially from IFRS



## **E. DERECOGNITION (L.O. 12-4)**

- Derecognize – remove liability from balance sheet
- Debt removed when extinguished – discharged, cancelled, expired
- Debt extinguished when paid off by cash or by providing goods or services
- Debt is extinguished when company no longer has legal obligation for the liability



## 1. Derecognition at Maturity

### At Maturity

- Amortized cost equals principal amount due
- There is no gain or loss on the extinguishment
- Derecognize as it is paid off.

Exhibit 12-14	Journal entry to record the derecognition of a maturing obligation	
2017 Jan 01	Dr. Bonds payable	1,000,000
	Dr. Interest payable	30,000
	Cr. Cash	1,030,000



## 2. Derecognition Prior to Maturity

Paying off before maturity - Required steps:

1. Update records to account for interim interest expense, amortization of discounts or premiums up to the derecognition date.
2. Record the outflow of assets expended to extinguish the obligation.
3. Record gain or loss on debt retirement equal to the amount paid minus and book value of the liability derecognized.



## Derecognition prior to Maturity (Continued)

- Companies may retire full amount of debt or a portion of it.
- Derecognition occurs on a pro rata basis when only a portion is retired.
- **See Exhibits 12-15 and 12-16**



### 3. Derecognition Through Offsetting and In-substance Defeasance

#### a. Offsetting

- showing net amounts of related assets and liabilities on the balance sheet
- IFRS prohibits offsetting unless company is:
  - Willing and legally able to offset(Such as two checking accounts in the same bank)



## Derecognition Through Offsetting and In-substance Defeasance (continued)

### Why Offset?

- Usually improves key financial ratios
- Easier to meet lenders' restrictive covenants with improved ratios
- Free up borrowing capacity as loan agreements typically limit the maximum debt carried



## b. In-substance Defeasance

- **In-substance defeasance** - an arrangement where funds sufficient to satisfy a liability are placed in trust with a third party to pay directly to the creditor at maturity
- Current accounting standards make this arrangement ineffective
- IAS 39 requires a legal release of the obligation
- Creditor has to formally confirm the entity is no longer liable.





## F. PUTTING IT ALL TOGETHER A COMPREHENSIVE BOND EXAMPLE

Note the following in **Exhibits 12-17a to 17e**

- Transaction costs are deducted from net proceeds of the bond issue
- Interest expense = cash interest paid + discount amortized
- Interest paid is face value of bond **x** coupon rate
- A gain or loss can result when bonds are retired
- Remove amortized cost from books on retirement.



## G. OTHER ISSUES

### 1. Decommissioning & Site Restoration Costs

- Addressed by IAS 37
- Provision recognized for estimated future liability discounted by an *appropriate* interest rate
- Increases asset cost and creates asset retirement obligations (AROs) or restoration obligation



## Decommissioning & Site Restoration Costs (continued)

- Interest expense recognized as ARO is amortized to maturity amount.
- ASPE standards similar, use accretion for interest.

See Exhibit 12-18; 12-19



## 2. Off-balance Sheet Obligations

- Accounting standards support reporting of all obligations on the balance sheet  
These include: - derivative contracts
  - Special Purpose Entities (SPEs)
  - decommissioning costs
  - finance leases
- One example of off-balance sheet financing technique that still exists: operating leases



### 3. Bonds Denominated in Foreign Currency

Governed by IAS 21.

1. Foreign currency debt translated into functional currency with rate on transaction date
2. Revalued at year-end using year-end rate
3. Gain/loss from revaluation recognized in income
4. Interest charged to expense at period's average rate
5. See Exhibit 12-21



## H. PRESENTATION AND DISCLOSURE (L.O. 12-5)

- Disclosure requirements are extensive
- Consideration of the following standards is necessary:
  - IAS 1
  - IAS 32
  - IAS 37
  - IAS 39
  - IFRS 7



## PRESENTATION AND DISCLOSURE (Continued)

Disclosures should cover

- The nature of contingent liabilities
- Summary policies for measuring/valuing liabilities
- Debt details including collateral pledged, call or conversion privileges
- Fair value of each class of liabilities and how determined



## PRESENTATION AND DISCLOSURE (Continued)

Disclosures should also cover

- Interest expense on debt not valued at fair value
- A schedule of contractual maturity dates of financial liabilities
- Nature and extent of risks arising from financial liabilities: credit risk, liquidity risks; market risk.
- Details of any obligations in default





# I. SUBSTANTIVE DIFFERENCES BETWEEN RELEVANT IFRS AND ASPE

Issue	IFRS	ASPE
Amortization of premiums and discounts on financial liabilities	Enterprises must use the effective interest method.	Enterprises may use either the effective interest method or the straight-line method because ASPE does not specify a method of amortization.
Increase in the provision for site restoration costs (ARO) due to the passage of time	Charged to interest expense	Charged to accretion expense



## J. SUMMARY

- L.O. 12-1. Describe financial leverage and its impact on profitability.
- L.O. 12-2. Describe the categories and types of non-current liabilities.
- L.O. 12-3. Describe the initial and subsequent measurement of non-current financial liabilities and account for these obligations.
- L.O. 12-4. Apply accrual accounting to the derecognition of financial liabilities.
- L.O. 12-5. Describe how non-current liabilities are presented and disclosed