This IFRS Supplement provides expanded discussions of accounting guidance under International Financial Reporting Standards (IFRS) for the topics in Intermediate Accounting. The discussions are organized according to the chapters in Intermediate Accounting (13th or 14th Editions) and therefore can be used to supplement the U.S. GAAP requirements as presented in the textbook. Assignment material is provided for each supplement chapter, which can be used to assess and reinforce student understanding of IFRS.

SECTION 1 • CURRENT LIABILITIES

CURRENT MATURITIES OF LONG-TERM DEBT

Delhaize Group (BEL) reports as part of its current liabilities the portion of bonds, mortgage notes, and other long-term indebtedness that matures within the next fiscal year. It categorizes this amount as current maturities of long-term debt. Companies, like Delhaize, exclude long-term debts maturing currently as current liabilities if they are to be:

1. Retired by assets accumulated for this purpose that properly have not been shown as current assets,
2. Refinanced, or retired from the proceeds of a new debt issue (discussed in the next section), or
3. Converted into ordinary shares.

When only a part of a long-term debt is to be paid within the next 12 months, as in the case of serial bonds that it retires through a series of annual installments, the company reports the maturing portion of long-term debt as a current liability, and the remaining portion as a long-term debt.

However, a company should classify as current any liability that is due on demand (callable by the creditor) or will be due on demand within a year (or operating cycle, if longer). Liabilities often become callable by the creditor when there is a violation of the debt agreement. For example, most debt agreements specify a given level of equity to debt be maintained, or specify that working capital be of a minimum amount. If the company violates an agreement, it must classify the debt as current because it is a reasonable expectation that existing working capital will be used to satisfy the debt.

To illustrate a breach of a covenant, assume that Gyro Company on November 1, 2011, has a long-term note payable to Sanchez Inc., which is due on April 1, 2013. Unfortunately, Gyro breaches a covenant in the note, and the obligation becomes payable on demand. Gyro is preparing its financial statements at December 31, 2011. Given the breach in the covenant, Gyro must classify its obligation as current. However, Gyro can classify the liability as non-current if Sanchez agrees before December 31, 2011, to provide a period of grace for the breach of the agreement. The period of grace must end at least 12 months after December 31, 2011, to be reported as a non-current liability. If the agreement is not finalized by December 31, 2011, Gyro must classify the note payable as a current liability. [1]

SHORT-TERM OBLIGATIONS EXPECTED TO BE REFINANCED

Short-term obligations are debts scheduled to mature within one year after the date of a company’s statement of financial position or within its normal operating cycle. Some short-term obligations are expected to be refinanced on a long-term basis. These
short-term obligations will not require the use of working capital during the next year (or operating cycle).\(^1\)

At one time, the accounting profession generally supported the exclusion of short-term obligations from current liabilities if they were “expected to be refinanced.” But the profession provided no specific guidelines, so companies determined whether a short-term obligation was “expected to be refinanced” based solely on management’s \textit{intent} to refinance on a long-term basis. Classification was not clear-cut. For example, a company might obtain a five-year bank loan but handle the actual financing with 90-day notes, which it must keep turning over (renewing). In this case, is the loan a long-term debt or a current liability? It depends on refinancing criteria.

## Refinancing Criteria

To resolve these classification problems, the IASB has developed criteria for determining the circumstances under which short-term obligations may be properly excluded from current liabilities. Specifically, a company can exclude a short-term obligation from current liabilities if both of the following conditions are met:

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

Intention to refinance on a long-term basis means that the company intends to refinance the short-term obligation so that it will not require the use of working capital during the ensuing fiscal year (or operating cycle, if longer). Entering into a financing arrangement that clearly permits the company to refinance the debt on a long-term basis on terms that are readily determinable before the next reporting date is one way to satisfy the second condition. In addition, the fact that a company has the right to refinance at any time and intends to do so permits the company to classify the liability as non-current.

To illustrate, assume that Haddad Company provides the following information related to its note payable.

- Issued note payable of €3,000,000 on November 30, 2011, due on February 28, 2012. Haddad’s reporting date is December 31, 2011.
- Haddad intends to extend the maturity date of the loan (refinance the loan) to June 30, 2013.
- The necessary paperwork to refinance the loan is completed on January 15, 2012. Haddad did not have an unconditional right to defer settlement of the obligation at December 31, 2011.

A graphical representation of the refinancing events is provided in Illustration 13-1.

A table showing the refinancing events:

<table>
<thead>
<tr>
<th>Liability of €3,000,000</th>
<th>Refinancing completed</th>
<th>Liability due for payment</th>
<th>Statements authorized for issuance</th>
</tr>
</thead>
</table>

In this case, Haddad must classify its note payable as a current liability because the refinancing was not completed by December 31, 2011, the financial reporting date. Only if the refinancing was completed before December 31, 2011, can Haddad classify the note obligation as non-current. The rationale: Refinancing a liability after the statement of financial position date does not affect the liquidity or solvency at the date of

---

\(^1\)Refinancing a short-term obligation on a long-term basis means either replacing it with a long-term obligation or equity securities, or renewing, extending, or replacing it with short-term obligations for an uninterrupted period extending beyond one year (or the normal operating cycle) from the date of the company’s statement of financial position.
the statement of financial position, the reporting of which should reflect contractual agreements in force on that date. [2]

What happens if Haddad has both the intention and the discretion (within the loan agreement) to refinance or roll over its €3,000,000 note payable to June 30, 2013? In this case, Haddad should classify the note payable as non-current because it has the ability to defer the payment to June 30, 2013.

DIVIDENDS PAYABLE

A cash dividend payable is an amount owed by a corporation to its shareholders as a result of board of directors’ authorization (or in other cases, vote of shareholders). At the date of declaration, the corporation assumes a liability that places the shareholders in the position of creditors in the amount of dividends declared. Because companies always pay cash dividends within one year of declaration (generally within three months), they classify them as current liabilities.

On the other hand, companies do not recognize accumulated but undeclared dividends on cumulative preference shares as a liability. Why? Because preference dividends in arrears are not an obligation until the board of directors authorizes the payment. Nevertheless, companies should disclose the amount of cumulative dividends unpaid in a note, or show it parenthetically in the share capital section.

Dividends payable in the form of additional shares are not recognized as a liability. Such share dividends (as we discuss in Chapter 15) do not require future outlays of assets or services. Companies generally report such undistributed share dividends in the equity section because they represent retained earnings in the process of transfer to share capital.

SECTION 2 • PROVISIONS

A provision is a liability of uncertain timing or amount (sometimes referred to as an estimated liability). Provisions are very common and may be reported either as current or non-current depending on the date of expected payment. [3] Common types of provisions are obligations related to litigation, warranties or product guarantees, business restructurings, and environmental damage.

For example, Vodafone (GBR) reported £906 million related to provisions for the costs of cleaning up contaminated sites and for legal and regulatory disputes. Nokia (FIN) reported €3,592 million for warranties, for intellectual property infringement disputes, and for restructuring costs. Nestlé Group (CHE) reported CHF3,663 million, primarily for restructuring and litigation costs.

The difference between a provision and other liabilities (such as accounts or notes payable, salaries payable, and dividends payable) is that a provision has greater uncertainty about the timing or amount of the future expenditure required to settle the obligation. For example, when Siemens AG (DEU) reports an accounts payable, there is an invoice or formal agreement as to the existence and the amount of the liability. Similarly, when Siemens accrues interest payable, the timing and the amount are known. [2]

RECOGNITION OF A PROVISION

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

1. A company has a present obligation (legal or constructive) as a result of a past event;
2. It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and
3. A reliable estimate can be made of the amount of the obligation.

[2] The distinction is important because provisions are subject to disclosure requirements that do not apply to other types of payables.
If these three conditions are not met, no provision is recognized. [4]

In applying the first condition, the past event (often referred to as the past obligating event) must have occurred. In applying the second condition, the term probable is defined as “more likely than not to occur.” This phrase is interpreted to mean the probability of occurrence is greater than 50 percent. If the probability is 50 percent or less, the provision is not recognized.

**Recognition Examples**

We provide three examples to illustrate when a provision should be recognized. It is assumed for each of these examples that a reliable estimate of the amount of the obligation can be determined. Illustration 13-2 presents the first example.

### ILLUSTRATION 13-2

**Provision Example 1**

**Warranty**

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

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

**Analysis:**

1. The warranty is a present obligation as a result of a past obligating event—the past obligating event is the sale of the product with a warranty, which gives rise to a legal obligation.
2. The warranty results in the outflow of resources embodying benefits in settlement—it is probable that there will be some claims related to these warranties.

**Conclusion:** Santos Company should recognize the provision.

When Santos sold its electrical products to customers, it undoubtedly signed a contract to warranty the product. In other words, Santos had a legal obligation to honor these warranties. A legal obligation generally results from a contract or legislation.

A **constructive obligation** is an obligation that derives from a company’s actions where:

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

Example 2 presented in Illustration 13-3 demonstrates how a constructive obligation is reported.

### ILLUSTRATION 13-3

**Provision Example 2**

**Refunds**

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

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

**Analysis:**

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

**Conclusion:** A provision is recognized for the best estimate of the costs of refunds.
Example 3, the case of Morrison Grocers (GBR), in Illustration 13-4 presents a situation in which the recognition of the provision depends on the probability of future payment.

**Lawsuit**

**Facts:** On November 30, 2011, assume that an employee filed a £1,000,000 lawsuit against Morrison Grocers for damages suffered when the employee slipped and suffered a serious injury at one of the company’s facilities. Morrison’s lawyers believe that Morrison will not lose the lawsuit, putting the probability at less than 50 percent.

**Question:** Should Morrison recognize a provision for legal claims at December 31, 2011?

**Analysis:** Although a past obligating event has occurred (the injury leading to the filing of the lawsuit), it is not probable (more likely than not) that Morrison will have to pay any damages.

**Conclusion:** Morrison does not need to record a provision. If, on the other hand, Morrison’s lawyer determined that it is probable that the company will lose the lawsuit, then Morrison should recognize a provision at December 31, 2011.

**MEASUREMENT OF PROVISIONS**

How does a company like Toyota (JPN), for example, determine the amount to report for its warranty cost on its automobiles? How does a company like Carrefour (FRA) determine its liability for customer refunds? Or, how does Novartis (CHE) determine the amount to report for a lawsuit that it probably will lose? And, how does a company like Total S.A. (FRA) determine the amount to report as a provision for its remediation costs related to environmental clean-up?

IFRS provides an answer: The amount recognized should be the best estimate of the expenditure required to settle the present obligation. Best estimate represents the amount that a company would pay to settle the obligation at the statement of financial position date. [5]

**Measurement Examples**

In determining the best estimate, the management of a company must use judgment, based on past or similar transactions, discussions with experts, and any other pertinent information. Here is how this judgment might be used in three different types of situations to arrive at best estimate:

- **Toyota warranties.** Toyota sells many cars and must make an estimate of the number of warranty repairs and related costs it will incur. Because it is dealing with a large population of automobiles, it is often best to weight all possible outcomes by associated probabilities. For example, it might determine that 80 percent of its cars will not have any warranty cost, 12 percent will have substantial costs, and 8 percent will have a much smaller cost. In this case, by weighting all the possible outcomes by their associated probabilities, Toyota arrives at an expected value for its warranty liability.

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

- **Novartis lawsuit.** Large companies like Novartis are involved in numerous litigation issues related to their products. Where a single obligation such as a lawsuit is being measured, the most likely outcome of the lawsuit may be the best estimate of the liability.
In each of these situations, the measurement of the liability should consider the time value of money, if material. In addition, future events that may have an impact on the measurement of the costs should be considered. For example, a company like Total S.A., which may have high remediation costs related to environmental clean-up, may consider future technological innovations that reduce future costs if reasonably certain of happening.

**COMMON TYPES OF PROVISIONS**

Here are some common areas for which provisions may be recognized in the financial statements:

1. Lawsuits  
2. Warranties  
3. Premiums  
4. Environmental  
5. Onerous contracts  
6. Restructuring

Although companies generally report only one current and one non-current amount for provisions in the statement of financial position, IFRS also requires extensive disclosure related to provisions in the notes to the financial statements. As discussed in the opening story, companies do not record or report in the notes to the financial statements general risk contingencies inherent in business operations (e.g., the possibility of war, strike, uninsurable catastrophes, or a business recession).

**Litigation Provisions**

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

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

To report a loss and a liability in the financial statements, the cause for litigation must have occurred on or before the date of the financial statements. It does not matter that the company became aware of the existence or possibility of the lawsuit or claims after the date of the financial statements but before issuing them. To evaluate the probability of an unfavorable outcome, a company considers the following: the nature of the litigation, the progress of the case, the opinion of legal counsel, its own and others’ experience in similar cases, and any management response to the lawsuit.

With respect to unfiled suits and unasserted claims and assessments, a company must determine (1) the degree of probability that a suit may be filed or a claim or assessment may be asserted, and (2) the probability of an unfavorable outcome. For example, assume that a regulatory body investigates the Nawtee Company for restraint of trade, and institutes enforcement proceedings. Private claims of triple damages for redress often follow such proceedings. In this case, Nawtee must determine the probability of the claims being asserted and the probability of triple damages being awarded. If both are probable, if the loss is reasonably estimable, and if the cause for action is dated on or before the date of the financial statements, then Nawtee should accrue the liability.

Companies can seldom predict the outcome of pending litigation, however, with any assurance. And, even if evidence available at the statement of financial position date does not favor the company, it is hardly reasonable to expect the company to
publish in its financial statements a dollar estimate of the probable negative outcome. Such specific disclosures might weaken the company’s position in the dispute and encourage the plaintiff to intensify its efforts. As a result, many companies provide a general provision for the costs expected to be incurred without relating the disclosure to any specific lawsuit or set of lawsuits. Illustration 13-5 provides the disclosure by Nestlé Group (CHE) related to its litigation claims.

**Nestlé Group**

**Notes to the financial statements (partial)**

**Litigation**

Litigation provisions have been set up to cover tax, legal and administrative proceedings that arise in the ordinary course of business. These provisions concern numerous cases whose detailed disclosure could seriously prejudice the interests of the Group. Reversal of such provisions refer to cases resolved in favor of the Group. The timing of cash outflows of litigation provisions is uncertain as it depends upon the outcome of the proceedings. These provisions are therefore not discounted because their present value would not represent meaningful information. Group Management does not believe it is possible to make assumptions on the evolution of the cases beyond the balance sheet date.

**ILLUSTRATION 13-5**

Litigation Disclosure

**Warranty Provisions**

A **warranty (product guarantee)** is a promise made by a seller to a buyer to make good on a deficiency of quantity, quality, or performance in a product. Manufacturers commonly use it as a sales promotion technique. Automakers, for instance, “hyped” their sales by extending their new-car warranty to seven years or 100,000 miles. For a specified period of time following the date of sale to the consumer, the manufacturer may promise to bear all or part of the cost of replacing defective parts, to perform any necessary repairs or servicing without charge, to refund the purchase price, or even to “double your money back.”

Warranties and guarantees entail future costs. These additional costs, sometimes called “after costs” or “post-sale costs,” frequently are significant. Although the future cost is indefinite as to amount, due date, and even customer, a liability is probable in most cases. Companies should recognize this liability in the accounts if they can reasonably estimate it. The estimated amount of the liability includes all the costs that the company will incur after sale and delivery and that are incident to the correction of defects or deficiencies required under the warranty provisions. Thus, warranty costs are a classic example of a provision.

Companies use two basic methods of accounting for warranty costs: (1) the cash-basis method and (2) the accrual method.

**Cash Basis**

Under the **cash-basis method**, companies expense warranty costs as incurred. In other words, a **seller or manufacturer charges warranty costs to the period in which it complies with the warranty**. The company does not record a liability for future costs arising from warranties, nor does it charge the period of sale. Companies frequently justify use of this method, the only one recognized for certain tax jurisdictions, on the basis of expediency when warranty costs are immaterial or when the warranty period is relatively short. A company must use the cash-basis method when it does not accrue a warranty liability in the year of sale either because:

1. It is not probable that a liability has been incurred, or
2. It cannot reasonably estimate the amount of the liability.
Accrual Basis
If it is probable that customers will make warranty claims and a company can reasonably estimate the costs involved, the company must use the accrual method. Under the **accrual method**, companies charge warranty costs to operating expense in the year of sale. The accrual method is the generally accepted method. Companies should use it whenever the warranty is an integral and inseparable part of the sale and is viewed as a provision. We refer to this approach as the **expense warranty approach**.

**Example of Expense Warranty Approach.** To illustrate the expense warranty method, assume that Denson Machinery Company begins production on a new machine in July 2011 and sells 100 units at $5,000 each by its year-end, December 31, 2011. Each machine is under warranty for one year. Denson estimates, based on past experience with a similar machine, that the warranty cost will average $200 per unit. Further, as a result of parts replacements and services rendered in compliance with machinery warranties, it incurs $4,000 in warranty costs in 2011 and $16,000 in 2012.

1. Sale of 100 machines at $5,000 each, July through December 2011:
   
<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash or Accounts Receivable</td>
<td>500,000</td>
</tr>
<tr>
<td>Sales</td>
<td>500,000</td>
</tr>
</tbody>
</table>

2. Recognition of warranty expense, July through December 2011:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Warranty Expense</td>
<td>4,000</td>
</tr>
<tr>
<td>Cash, Inventory, Accrued Payroll</td>
<td></td>
</tr>
<tr>
<td>(Warranty costs incurred)</td>
<td>4,000</td>
</tr>
<tr>
<td>Warranty Expense</td>
<td>16,000</td>
</tr>
<tr>
<td>Warranty Liability</td>
<td></td>
</tr>
<tr>
<td>(To accrue estimated warranty costs)</td>
<td>16,000</td>
</tr>
</tbody>
</table>

   The December 31, 2011, statement of financial position reports “Warranty liability” as a current liability of $16,000, and the income statement for 2011 reports “Warranty expense” of $20,000.

3. Recognition of warranty costs incurred in 2012 (on 2011 machinery sales):

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Warranty Liability</td>
<td>16,000</td>
</tr>
<tr>
<td>Cash, Inventory, Accrued Payroll</td>
<td></td>
</tr>
<tr>
<td>(Warranty costs incurred)</td>
<td>16,000</td>
</tr>
</tbody>
</table>

   If Denson Machinery applies the cash-basis method, it reports $4,000 as warranty expense in 2011 and $16,000 as warranty expense in 2012. It records all of the sale price as revenue in 2011. In many instances, application of the cash-basis method fails to record the warranty costs relating to the products sold during a given period with the revenues derived from such products. As such, it violates the expense recognition principle. Where ongoing warranty policies exist year after year, the differences between the cash and the expense warranty bases probably would not be significant.

**Sales Warranty Approach.** A warranty is sometimes sold separately from the product. For example, when you purchase a television set or DVD player, you are entitled to the manufacturer’s warranty. You also will undoubtedly be offered an extended warranty on the product at an additional cost.3

---

3A company separately prices a contract if the customer has the option to purchase the services provided under the contract for an expressly stated amount separate from the price of the product. An extended warranty or product maintenance contract usually meets these conditions.
In this case, the seller should recognize the sale of the television or DVD player with the manufacturer’s warranty separately from the sale of the extended warranty. This approach is referred to as the sales warranty approach. **Companies defer revenue on the sale of the extended warranty** and generally recognize it on a straight-line basis over the life of the contract. The seller of the warranty defers revenue because it has an obligation to perform services over the life of the contract. The seller should only defer and amortize costs that vary with and are directly related to the sale of the contracts (mainly commissions). It expenses those costs, such as employees’ salaries, advertising, and general and administrative expenses, that it would have incurred even if it did not sell a contract.

To illustrate, assume you purchase a new automobile from Hanlin Auto for $20,000. In addition to the regular warranty on the auto (the manufacturer will pay for all repairs for the first 36,000 miles or three years, whichever comes first), you purchase at a cost of $600 an extended warranty that protects you for an additional three years or 36,000 miles. Hanlin Auto records the sale of the automobile (with the regular warranty) and the sale of the extended warranty on January 2, 2011, as follows.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>20,600</td>
</tr>
<tr>
<td>Sales</td>
<td>20,000</td>
</tr>
<tr>
<td>Unearned Warranty Revenue</td>
<td>600</td>
</tr>
</tbody>
</table>

It recognizes revenue at the end of the fourth year (using straight-line amortization) as follows.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unearned Warranty Revenue</td>
<td>200</td>
</tr>
<tr>
<td>Warranty Revenue</td>
<td>200</td>
</tr>
</tbody>
</table>

Because the extended warranty contract only starts after the regular warranty expires, Hanlin Auto defers revenue recognition until the fourth year. If it incurs the costs of performing services under the extended warranty contract on other than a straight-line basis (as historical evidence might indicate), Hanlin Auto should recognize revenue over the contract period in proportion to the costs it expected to incur in performing services under the contract.

**Premiums and Coupons**

Numerous companies offer premiums (either on a limited or continuing basis) to customers in return for boxtops, certificates, coupons, labels, or wrappers. The premium may be silverware, dishes, a small appliance, a toy, or free transportation. Also, printed coupons that can be redeemed for a cash discount on items purchased are extremely popular. Another popular marketing innovation is the cash rebate, which the buyer can obtain by returning the store receipt, a rebate coupon, and Universal Product Code (UPC label) or “bar code” to the manufacturer.4

Companies offer premiums, coupon offers, and rebates to stimulate sales. Thus, companies should charge the costs of premiums and coupons to expense in the period of the sale that benefits from the plan. The period that benefits is not necessarily the period in which the company offered the premium. At the end of the accounting period, many premium offers may be outstanding and must be redeemed when

---

4In the United States, nearly 40 percent of cash rebates never get redeemed, and some customers complain about how difficult the rebate process is. See B. Grow, “The Great Rebate Runaround,” *BusinessWeek* (December 5, 2005). Approximately 4 percent of coupons are redeemed. Redeemed coupons eventually make their way to the corporate headquarters of the stores that accept them. From there, they are shipped to clearinghouses operated by A. C. Nielsen Company (USA) (of TV-rating fame) that count them and report back to the manufacturers who, in turn, reimburse the stores.
presented in subsequent periods. In order to reflect the existing current liability and to match costs with revenues, the company estimates the number of outstanding premium offers that customers will present for redemption. The company then charges the cost of premium offers to Premium Expense. It credits the outstanding obligations to an account titled Premium Liability.

The following example illustrates the accounting treatment for a premium offer. Fluffy Cakemix Company offered its customers a large non-breakable mixing bowl in exchange for 25 cents and 10 boxtops. The mixing bowl costs Fluffy Cakemix Company 75 cents, and the company estimates that customers will redeem 60 percent of the boxtops. The premium offer began in June 2011 and resulted in the transactions journalized below. Fluffy Cakemix Company records purchase of 20,000 mixing bowls at 75 cents as follows.

\[
\begin{align*}
\text{Inventory of Premium Mixing Bowls} & \quad 15,000 \\
\text{Cash} & \quad 15,000
\end{align*}
\]

The entry to record sales of 300,000 boxes of cake mix at 80 cents would be:

\[
\begin{align*}
\text{Cash} & \quad 240,000 \\
\text{Sales} & \quad 240,000
\end{align*}
\]

Fluffy records the actual redemption of 60,000 boxtops, the receipt of 25 cents per 10 boxtops, and the delivery of the mixing bowls as follows.

\[
\begin{align*}
\text{Cash} & \quad [60,000 \div 10] \times \$0.25 \\
\text{Premium Expense} & \quad 3,000 \\
\text{Inventory of Premium Mixing Bowls} & \quad 4,500 \\
\text{Computation:} & \quad (60,000 \div 10) \times \$0.75 = $4,500
\end{align*}
\]

Finally, Fluffy makes an end-of-period adjusting entry for estimated liability for outstanding premium offers (boxtops) as follows.

\[
\begin{align*}
\text{Premium Expense} & \quad 6,000 \\
\text{Premium Liability} & \quad 6,000 \\
\text{Computation:} & \\
\text{Total boxtops sold in 2011} & \quad 300,000 \\
\text{Total estimated redemptions (60%)} & \quad 180,000 \\
\text{Boxtops redeemed in 2011} & \quad (60,000) \\
\text{Estimated future redemptions} & \quad 120,000 \\
\text{Cost of estimated claims outstanding} & \quad (120,000 \div 10) \times ($0.75 - $0.25) = $6,000
\end{align*}
\]

The December 31, 2011, statement of financial position of Fluffy Cakemix Company reports an “Inventory of premium mixing bowls” of $10,500 as a current asset and “Premium liability” of $6,000 as a current liability. The 2011 income statement reports a $9,000 “Premium expense” among the selling expenses.

**Environmental Provisions**

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

In many industries, the construction and operation of long-lived assets involves obligations for the retirement of those assets. When a mining company opens up a strip mine, it may also commit to restore the land once it completes mining. Similarly, when an oil company erects an offshore drilling platform, it may be legally obligated to dismantle and remove the platform at the end of its useful life.
Accounting Recognition of Environmental Liabilities

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

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

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

In order to capture the benefits of these long-lived assets, the company is generally legally obligated for the costs associated with retirement of the asset, whether the company hires another party to perform the retirement activities or performs the activities with its own workforce and equipment. Environmental liabilities give rise to various recognition patterns. For example, the obligation may arise at the outset of the asset’s use (e.g., erection of an oil-rig), or it may build over time (e.g., a landfill that expands over time).

Measurement. A company initially measures an environmental liability at the best estimate of its future costs. The estimate should reflect the amount a company would pay in an active market to settle its obligation (essentially fair value). While active markets do not exist for many environmental liabilities, companies should estimate fair value based on the best information available. Such information could include market prices of similar liabilities, if available. Alternatively, companies may use present value techniques to estimate fair value.

Recognition and Allocation. To record an environmental liability in the financial statements, a company includes the cost associated with the environmental liability in the carrying amount of the related long-lived asset, and records a liability for the same amount. It records the environmental costs as part of the related asset because these costs are tied to operating the asset and are necessary to prepare the asset for its intended use. Therefore, the specific asset (e.g., mine, drilling platform, nuclear power plant) should be increased because the future economic benefit comes from the use of this productive asset. Companies should not record the capitalized environmental costs in a separate account because there is no future economic benefit that can be associated with these costs alone.

In subsequent periods, companies allocate the cost of the asset to expense over the period of the related asset’s useful life. Companies may use the straight-line method for this allocation, as well as other systematic and rational allocations.

Example of Accounting Provisions. To illustrate the accounting for these types of environmental liabilities, assume that on January 1, 2011, Wildcat Oil Company erected an oil platform in the Gulf of Mexico. Wildcat is legally required to dismantle and remove the platform at the end of its useful life, estimated to be five years. Wildcat estimates that dismantling and removal will cost $1,000,000. Based on a 10 percent discount rate, the fair value of the environmental liability is estimated to be $620,920 ($1,000,000 × .62092). Wildcat records this liability as follows.

<table>
<thead>
<tr>
<th>Date</th>
<th>Account Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 1, 2011</td>
<td>Drilling Platform</td>
<td>620,920</td>
</tr>
<tr>
<td></td>
<td>Environmental Liability</td>
<td>620,920</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciation Expense ($620,920 ÷ 5)</td>
<td>124,184</td>
</tr>
<tr>
<td>Accumulated Depreciation</td>
<td>124,184</td>
</tr>
</tbody>
</table>

In addition, Wildcat must accrue interest expense each period. Wildcat records interest expense and the related increase in the environmental liability on December 31, 2011, as follows.

December 31, 2011

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest Expense ($620,920 × 10%)</td>
<td>62,092</td>
</tr>
<tr>
<td>Environmental Liability</td>
<td>62,092</td>
</tr>
</tbody>
</table>

On January 10, 2016, Wildcat contracts with Rig Reclaimers, Inc. to dismantle the platform at a contract price of $995,000. Wildcat makes the following journal entry to record settlement of the liability.

January 10, 2016

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Environmental Liability</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Gain on Settlement of Environmental Liability</td>
<td>5,000</td>
</tr>
<tr>
<td>Cash</td>
<td>995,000</td>
</tr>
</tbody>
</table>

As indicated, as a result of the discounting, Wildcat incurs two types of costs: (1) an operating cost related to depreciation expense, and (2) a finance cost related to interest expense. The recording of the interest expense is often referred to as “unwinding the discount,” which refers to the fact that the obligation was discounted as a result of present value computations. This discount can be substantial. For example, when BP plc (GBR) changed its policy and started discounting its environmental provision, it decreased its initial obligation by £350 million.

A company like Wildcat can consider future events when considering the measurement of the liability. For example, a technological development that will make restoration less expensive and is virtually certain to happen should be considered. Generally, future events are limited to those that are virtually certain to happen, as well as technology advances or proposed legislation that will impact future costs.

**Onerous Contract Provisions**

Sometimes, companies have what are referred to as *onerous contracts*. These contracts are ones in which “the unavoidable costs of meeting the obligations exceed the economic benefits expected to be received.” [7] An example of an onerous contract is a loss recognized on unfavorable non-cancelable purchase commitments related to inventory items (discussed in Chapter 9).

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

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loss on Lease Contract</td>
<td>200,000</td>
</tr>
<tr>
<td>Lease Contract Liability</td>
<td>200,000</td>
</tr>
</tbody>
</table>

The expected costs should reflect the least net cost of exiting from the contract, which is the lower of (1) the cost of fulfilling the contract, or (2) the compensation or penalties arising from failure to fulfill the contract.

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

Illustration 13-6 indicates how Nestlé Group (CHE) discloses onerous contracts.
Restructuring Provisions

The accounting for restructuring provisions is controversial. Once companies make a decision to restructure part of their operations, they have the temptation to charge as many costs as possible to this provision. The rationale: Many believe analysts often dismiss these costs as not part of continuing operations and therefore somewhat irrelevant in assessing the overall performance of the company. Burying as many costs as possible in a restructuring provision therefore permits companies to provide a more optimistic presentation of current operating results.

On the other hand, companies are continually in a state of flux, and what constitutes a restructuring is often difficult to assess. One thing is certain—companies should not be permitted to provide for future operating losses in the current period when accounting for restructuring costs. Nor should they be permitted to bury operating costs in the restructuring cost classification. [8]

As a consequence, IFRS is very restrictive regarding when a restructuring provision can be recorded and what types of costs may be included in a restructuring provision. Restructurings are defined as a “program that is planned and controlled by management and materially changes either (1) the scope of a business undertaken by the company; or (2) the manner in which that business is conducted.” Examples of restructurings are the sale of a line of business, changes in management structures such as eliminating a layer of management, or closure of operations in a country.

For a company to record restructuring costs and a related liability, it must meet the general requirements for recording provisions discussed earlier. In addition, to assure that the restructuring is valid, companies are required to have a detailed formal plan for the restructuring and to have raised a valid expectation to those affected by implementation or announcement of the plan.

Only direct incremental costs associated with the restructuring may be included in the restructuring provision. At the same time, IFRS provides specific guidance related to certain costs and losses that should be excluded from the restructuring provision. Illustration 13-7 provides a summary of costs that may and may not be included in a restructuring provision.

<table>
<thead>
<tr>
<th>Costs Included (direct, incremental)</th>
<th>Costs Excluded</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Employee termination costs related directly to the restructuring.</td>
<td>• Investment in new systems.</td>
</tr>
<tr>
<td>• Contract termination costs, such as lease termination penalties.</td>
<td>• Lower utilization of facilities.</td>
</tr>
<tr>
<td>• Onerous contract provisions.</td>
<td>• Costs of training or relocating staff.</td>
</tr>
<tr>
<td></td>
<td>• Costs of moving assets or operations.</td>
</tr>
<tr>
<td></td>
<td>• Administration or marketing costs.</td>
</tr>
<tr>
<td></td>
<td>• Allocations of corporate overhead.</td>
</tr>
<tr>
<td></td>
<td>• Expected future operating costs or expected operating losses unless they relate to an onerous contract.</td>
</tr>
</tbody>
</table>

ILLUSTRATION 13-7
Costs Included/Excluded from Restructuring Provision
In general, the costs-excluded list is comprised of expenditures that relate to the future operations of the business and are not liabilities associated with the restructuring as of the end of the reporting period. Therefore, such expenditures are recognized on the same basis as if they arose independently of a restructuring. [9]

The case of Rodea Group’s solar panel division, presented in Illustration 13-8, provides an example of a restructuring.

**ILLUSTRATION 13-8**
Restructuring Example

**Closure of Division**

*Facts:* On December 12, 2011, the board of Rodea decided to close down a division making solar panels. On December 20, 2011, a detailed plan for closing down the division was agreed to by the board; letters were sent to customers warning them to seek an alternative source of supply and termination notices were sent to the staff of the division. Rodea estimates that it is probable that it will have €500,000 in restructuring costs.

*Question:* Should Rodea report a restructuring liability if it has costs related to the restructuring?

*Analysis:* (1) The past obligating event for Rodea is the communication of the decision to the customers and employees, which gives rise to a constructive obligation on December 31, 2011, because it creates a valid expectation that the division will be closed. (2) An outflow of resources in settlement is probable and reliably estimated.

*Conclusion:* A provision is recognized at December 31, 2011, for the best estimate of closing the division, in this case, €500,000.

**Self-Insurance**

As discussed earlier, liabilities are not recorded for general risks (e.g., losses that might arise due to poor expected economic conditions). Similarly, companies do not record liabilities for more specific future risks such as allowances for repairs. The reason: These items do not meet the definition of a liability because they do not arise from a past transaction but instead relate to future events.

Some companies take out insurance policies against the potential losses from fire, flood, storm, and accident. Other companies do not. The reasons: Some risks are not insurable, the insurance rates are prohibitive (e.g., earthquakes and riots), or they make a business decision to self-insure. Self-insurance is another item that is not recognized as a provision.

Despite its name, **self-insurance** is not insurance but risk assumption. Any company that assumes its own risks puts itself in the position of incurring expenses or losses as they occur. There is little theoretical justification for the establishment of a liability based on a hypothetical charge to insurance expense. This is “as if” accounting. The conditions for accrual stated in IFRS are not satisfied prior to the occurrence of the event. Until that time, there is no diminution in the value of the property. And unlike an insurance company, which has contractual obligations to reimburse policyholders for losses, a company can have no such obligation to itself and, hence, no liability either before or after the occurrence of damage.5

Exposure to risks of loss resulting from uninsured past injury to others, however, is an existing condition involving uncertainty about the amount and timing of losses that may develop. A company with a fleet of vehicles for example, would have to accrue uninsured losses resulting from injury to others or damage to the property of others that took place prior to the date of the financial statements (if the experience of the

---

5A commentary in the financial magazine Forbes (June 15, 1974) stated its position on this matter quite succinctly: “The simple and unquestionable fact of life is this: Business is cyclical and full of unexpected surprises. Is it the role of accounting to disguise this unpleasant fact and create a fairyland of smoothly rising earnings? Or, should accounting reflect reality, warts and all—floods, expropriations and all manner of rude shocks?”
company or other information enables it to make a reasonable estimate of the liability). However, it should not establish a liability for expected future injury to others or damage to the property of others, even if it can reasonably estimate the amount of losses.

DISCLOSURES RELATED TO PROVISIONS

The disclosures related to provisions are extensive. A company must provide a reconciliation of its beginning to ending balance for each major class of provisions, identifying what caused the change during the period. In addition, the provision must be described and the expected timing of any outflows disclosed. Also, disclosure about uncertainties related to expected outflows as well as expected reimbursements should be provided. [10] Illustration 13-9 provides an example, based on the provisions note in Nokia’s (FIN) annual report.

Illustration 13-9

Provisions Disclosure

Notes to the Financial Statements (partial)
27. Provisions
(€000,000)

<table>
<thead>
<tr>
<th></th>
<th>Warranty</th>
<th>Restructuring</th>
<th>IPR infringements</th>
<th>Tax</th>
<th>Other</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>At January 1, 2008</td>
<td>1,489</td>
<td>617</td>
<td>545</td>
<td>452</td>
<td>614</td>
<td>3,717</td>
</tr>
<tr>
<td>Exchange differences</td>
<td>−16</td>
<td>−17</td>
<td>−17</td>
<td>−17</td>
<td>−17</td>
<td>−17</td>
</tr>
<tr>
<td>Acquisitions</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Additional provisions</td>
<td>1,211</td>
<td>533</td>
<td>266</td>
<td>47</td>
<td>1,136</td>
<td>3,193</td>
</tr>
<tr>
<td>Change in fair value</td>
<td>−240</td>
<td>−240</td>
<td>−240</td>
<td>−240</td>
<td>−240</td>
<td>−240</td>
</tr>
<tr>
<td>Changes in estimates</td>
<td>−240</td>
<td>−240</td>
<td>−240</td>
<td>−240</td>
<td>−240</td>
<td>−240</td>
</tr>
<tr>
<td>Utilized during year</td>
<td>−1,070</td>
<td>−1,070</td>
<td>−1,070</td>
<td>−1,070</td>
<td>−1,070</td>
<td>−1,070</td>
</tr>
<tr>
<td>At December 31, 2008</td>
<td>1,375</td>
<td>356</td>
<td>343</td>
<td>460</td>
<td>1,058</td>
<td>3,592</td>
</tr>
<tr>
<td>Charged to profit and loss account</td>
<td>971</td>
<td>322</td>
<td>174</td>
<td>2</td>
<td>944</td>
<td>2,413</td>
</tr>
</tbody>
</table>

Analysis of total provisions at December 31:
2008     2007
Non-current 978   1,323
Current  2,614  2,394

Outflows for the warranty provision are generally expected to occur within the next 18 months. Timing of outflows related to tax provisions is inherently uncertain.

The restructuring provision is mainly related to restructuring activities in Devices & Services and Nokia Siemens Networks segments. The majority of outflows related to the restructuring is expected to occur during 2009.

In conjunction with the Group’s decision to discontinue the production of mobile devices in Germany, a restructuring provision of EUR 259 million was recognized. Devices & Services also recognized EUR 52 million charges related to other restructuring activities.


The IPR provision is based on estimated future settlements for asserted and unasserted past IPR infringements. Final resolution of IPR claims generally occurs over several periods. In 2008, EUR 379 million usage of the provisions mainly relates to the settlements with Qualcomm, Eastman Kodak, Intertrust Technologies and ContentGuard.

Other provisions include provisions for non-cancelable purchase commitments, provision for pension and other social costs on share-based awards and provision for losses on projects in progress.

6This type of situation is often referred to as “an incurred but not reported” (IBNR) provision. A company may not be able to identify the claims giving rise to the obligation, but it knows a past obligating event has occurred.
In a general sense, all provisions are contingent because they are uncertain in timing or amount. However, IFRS uses the term “contingent” for liabilities and assets that are not recognized in the financial statements. [11]

CONTINGENT LIABILITIES

Contingent liabilities are not recognized in the financial statements because they are (1) a possible obligation (not yet confirmed as a present obligation), (2) a present obligation for which it is not probable that payment will be made, or (3) a present obligation for which a reliable estimate of the obligation cannot be made. Examples of contingent liabilities are:

- A lawsuit in which it is only possible that the company might lose.
- A guarantee related to collectability of a receivable.

Illustration 13-10 presents the general guidelines for the accounting and reporting of contingent liabilities.

<table>
<thead>
<tr>
<th>Outcome</th>
<th>Probability*</th>
<th>Accounting Treatment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Virtually certain</td>
<td>At least 90%</td>
<td>Report as liability (provision).</td>
</tr>
<tr>
<td>Probable (more likely than not)</td>
<td>51–89% probable</td>
<td>Report as liability (provision).</td>
</tr>
<tr>
<td>Possible but not probable</td>
<td>5–50%</td>
<td>Disclosure required.</td>
</tr>
<tr>
<td>Remote</td>
<td>Less than 5%</td>
<td>No disclosure required.</td>
</tr>
</tbody>
</table>

*In practice, the percentages for virtually certain and remote may deviate from those presented here.

Unless the possibility of any outflow in settlement is remote, companies should disclose the contingent liability at the end of the reporting period, providing a brief description of the nature of the contingent liability and, where practicable:

1. An estimate of its financial effect;
2. An indication of the uncertainties relating to the amount or timing of any outflow; and
3. The possibility of any reimbursement.

Illustration 13-11 provides a disclosure by Barloworld Limited (ZAF) related to its contingent liabilities.

<table>
<thead>
<tr>
<th>Contingent liabilities</th>
<th>2009</th>
<th>2008</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bills, lease and hire-purchase agreements discounted with recourse, other guarantees and claims</td>
<td>1,212</td>
<td>1,066</td>
<td>989</td>
</tr>
<tr>
<td>Buy-back and repurchase commitments not reflected on the balance sheet</td>
<td>294</td>
<td>517</td>
<td>449</td>
</tr>
</tbody>
</table>

The related assets are estimated to have a value at least equal to the repurchase commitment.

The group has given guarantees to the purchaser of the coatings Australian business relating to environmental claims. The guarantees are for a maximum period of eight years and are limited to the sales price received for the business. Freeworld Coatings Limited is responsible for the first AUD5 million of any claim in terms of the unbundling arrangement.

Warranties and guarantees have been given as a consequence of the various disposals completed during the year and prior years. None are expected to have a material impact on the financial results of the group.

There are no material contingent liabilities in joint venture companies. Litigation, current or pending, is not considered likely to have a material adverse effect on the group.
CONTINGENT ASSETS

A **contingent asset** is a possible asset that arises from past events and whose existence will be confirmed by the occurrence or non-occurrence of uncertain future events not wholly within the control of the company. [12] Typical contingent assets are:

1. Possible receipts of monies from gifts, donations, bonuses.
2. Possible refunds from the government in tax disputes.
3. Pending court cases with a probable favorable outcome.

Contingent assets are not recognized on the statement of financial position. If realization of the contingent asset is virtually certain, it is no longer considered a contingent asset and is recognized as an asset. **Virtually certain** is generally interpreted to be at least a probability of 90 percent or more.

The general rules related to contingent assets are presented in Illustration 13-12.

<table>
<thead>
<tr>
<th>Outcome</th>
<th>Probability*</th>
<th>Accounting Treatment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Virtually certain</td>
<td>At least 90% probable</td>
<td>Report as asset (no longer contingent).</td>
</tr>
<tr>
<td>Probable (more likely than not)</td>
<td>51–90% probable</td>
<td>Disclose.</td>
</tr>
<tr>
<td>Possible but not probable</td>
<td>5–50%</td>
<td>No disclosure required.</td>
</tr>
<tr>
<td>Remote</td>
<td>Less than 5%</td>
<td>No disclosure required.</td>
</tr>
</tbody>
</table>

*In practice, the percentages for virtually certain and remote may deviate from those presented here.

Contingent assets are disclosed when an inflow of economic benefits is considered more likely than not to occur (greater than 50 percent). However, it is important that disclosures for contingent assets avoid giving misleading indications of the likelihood of income arising. As a result, it is not surprising that the thresholds for allowing recognition of contingent assets are more stringent relative to those for liabilities.

What might be an example of a contingent asset that becomes an asset to be recorded? To illustrate, assume that Marcus Realty leases a property to **Marks and Spencer plc (M&S)** (GBR). The contract is non-cancelable for five years. On December 1, 2011, before the end of the contract, M&S withdraws from the contract and is required to pay £245,000 as a penalty. At the time M&S cancels the contract, a receivable and related income should be reported by Marcus. The disclosure includes the nature and, where practicable, the estimated financial effects of the asset.

**U.S. GAAP PERSPECTIVE**

The criteria for recognizing contingent assets are less stringent under U.S. GAAP. That is, contingent assets for insurance recoveries are recognized if probable under U.S. GAAP; IFRS requires recoveries to be “virtually certain” before recognition of the asset is permitted.

**AUTHORITATIVE LITERATURE**

**Authoritative Literature References**

BRIEF EXERCISES

BE13-1  Management at Eli Company has decided to close one of its plants. It will continue to operate the plant for approximately one year. It anticipates the following costs will be incurred as a result of this closing: (1) termination compensation costs, (2) marketing costs to rebrand the company image, (3) future losses for keeping the plant open for another year, and (4) lease termination costs related to the closing. Indicate which, if any, of these costs should not be considered restructuring costs for purposes of establishing a provision.

BE13-2  Luckert Company decided to cancel an existing lease on properties in one of its divisions, as its operations in this area were no longer profitable. Unfortunately, Luckert has a non-cancelable lease and cannot sublease the property. The present value of future lease payments under the lease is $2,000,000. The penalty to break the lease is $1,450,000. Prepare the journal entry to record this cancelation.

EXERCISES

E13-1  (Refinancing of Short-Term Debt)  On December 31, 2010, Alexander Company had €1,200,000 of short-term debt in the form of notes payable due February 2, 2011. On January 21, 2011, the company issued 25,000 ordinary shares for €36 per share, receiving €900,000 proceeds after brokerage fees and other costs of issuance. On February 2, 2011, the proceeds from the share sale, supplemented by an additional €300,000 cash, are used to liquidate the €1,200,000 debt. The December 31, 2010, statement of financial position is authorized for issue on February 23, 2011.
Instructions
Show how the €1,200,000 of short-term debt should be presented on the December 31, 2010, statement of financial position.

E13-2  (Debt Classifications)  Presented below are four different situations related to Mckee Corporation debt obligations. Mckee’s next financial reporting date is December 31, 2010. The financial statements are authorized for issuance on March 1, 2011.

1. Mckee has a debt obligation maturing on December 31, 2013. The debt is callable on demand by the lender at any time.
2. Mckee also has a long-term obligation due on December 1, 2012. On November 10, 2010, it breaches a covenant on its debt obligation and the loan becomes due on demand. An agreement is reached to provide a waiver of the breach on December 8, 2010.
3. Mckee has a long-term obligation of $400,000, which is maturing over 4 years in the amount of $100,000 per year. The obligation is dated November 1, 2010, and the first maturity date is November 1, 2011.

Instructions
Indicate how each of these debt obligations is reported on Mckee’s statement of financial position on December 31, 2010.

E13-3  (Restructuring Issues)  EADS Company is involved in a restructuring related to its energy division. The company controller and CFO are considering the following costs to accrue as part of the restructuring. The costs are as follows (amounts in ¥000).

1. The company has a long-term lease on one of the facilities related to the division. It is estimated that it will have to pay a penalty cost of ¥400,000 to break the lease. The company estimates that the present value related to payments on the lease contract are ¥650,000.
2. The company’s allocation of overhead costs to other divisions will increase by ¥1,500,000 as a result of restructuring these facilities.
3. Due to the restructuring, some employees will be shifted to some of the other divisions. The cost of retraining these individuals is estimated to be ¥2,000,000.
4. The company has hired an outplacement firm to help them in dealing with the number of terminations related to the restructuring. It is estimated the cost for this company will be ¥600,000.
5. It is estimated that employee termination costs will be ¥3,000,000.
6. The company believes that it will cost ¥320,000 to move useable assets from the energy division to other divisions in the company.

Instructions
Indicate how each of these costs should be reported in the financial statements.

E13-4  (Restructuring)  On December 31, 2010, the board of Dolman Group decided to close one of its divisions. On December 31, 2010, a detailed plan for closing the division was agreed to by the board, and letters were sent to customers and employees affected by this closure.

Instructions
(a) What is a restructuring? Provide two examples.
(b) To ensure that the restructuring is valid, what two conditions must take place?
(c) Possible costs that may be incurred during the restructuring are as follows: (1) investment in new software as a result of closing the division, (2) cost of moving some assets of the closed division to other parts of the company, (3) employee termination costs related to closing the division, (4) expected future operation losses in closing the division, and (5) onerous contract provisions related to the closing. Indicate which (if any) of these costs may be part of a restructuring provision.

E13-5  (Provisions and Contingencies)  Presented below are three independent situations. Answer the question at the end of each situation.

1. During 2010, Maverick Inc. became involved in a tax dispute with the government. Maverick’s attorneys have indicated that they believe it is probable that Maverick will lose this dispute. They also believe that Maverick will have to pay the government between $800,000 and $1,400,000. After the 2010 financial statements were issued, the case was settled with the government for $1,200,000. What amount, if any, should be reported as a liability for this tax dispute as of December 31, 2010?
2. On October 1, 2010, Holmgren Chemical was identified as a potentially responsible party by its Environmental Regulatory Agency. Holmgren’s management along with its counsel have concluded that it is probable that Holmgren will be responsible for damages, and a reasonable estimate of these damages is $6,000,000. Holmgren’s insurance policy of $9,000,000 has a deductible clause of $500,000. How should Holmgren Chemical report this information in its financial statements at December 31, 2010?

3. Shinobi Inc. had a manufacturing plant in Darfur, which was destroyed in the civil war. It is not certain who will compensate Shinobi for this destruction, but Shinobi has been assured by governmental officials that it will receive a definite amount for this plant. The amount of the compensation will be less than the fair value of the plant but more than its book value. How should the compensation be reported in the financial statements of Shinobi Inc.?

E13-6 (Provisions) The following situations relate to Bolivia Company.

1. Bolivia provides a warranty with all its products it sells. It estimates that it will sell 1,000,000 units of its product for the year ended December 31, 2010, and that its total revenue for the product will be $100,000,000. It also estimates that 60% of the product will have no defects, 30% will have major defects, and 10% will have minor defects. The cost of a minor defect is estimated to be $5 for each product sold, and the cost for a major defect cost is $15. The company also estimates that the minimum amount of warranty expense will be $2,000,000 and the maximum will be $10,000,000.

2. Bolivia is involved in a tax dispute with the tax authorities. The most likely outcome of this dispute is that Bolivia will lose and have to pay $400,000. The minimum it will lose is $20,000 and the maximum is $2,500,000.

3. Bolivia has a policy of refunding purchases to dissatisfied customers, even though it is under no obligation to do so. However, it has created a valid expectation with its customers to continue this practice. These refunds can range from 5% of sales to 9% of sales, with any amount in between a reasonable possibility. In 2010, Bolivia has $80,000,000 of sales subject to possible refund. The average cost of any refund item is $12.

Instructions
Prepare the journal entry to record provisions, if any, for Bolivia at December 31, 2010.
exists at the date of issuance of the financial statements. Assume further that the current portion of long-term debt does not mature until August 2011. In addition, management may refinance the ¥10,000,000 obligation under the terms of the financial agreement with the bank, which is expected to be financially capable of honoring the agreement. Given these facts, should the ¥10,000,000 be classified as current on the statement of financial position at December 31, 2010?

**FINANCIAL REPORTING**

**Financial Reporting Problem**

**Marks and Spencer plc (M&S)**

The financial statements of M&S can be accessed at the book’s companion website, [www.wiley.com/college/kiesoifrs](http://www.wiley.com/college/kiesoifrs).

**Instructions**

Refer to M&S’s financial statements and the accompanying notes to answer the following questions.

(a) What was M&S’s 2008 short-term debt and related weighted-average interest rate on this debt?
(b) What was M&S’s 2008 working capital, acid-test ratio, and current ratio? Comment on M&S’s liquidity.
(c) What types of commitments and contingencies has M&S reported in its financial statements? What is management’s reaction to these contingencies?

**BRIDGE TO THE PROFESSION**

**Professional Research**

Hincapie Co. manufactures specialty bike accessories. The company is most well known for its product quality, and it has offered one of the best warranties in the industry on its higher-priced products—a lifetime guarantee. The warranty on these products is included in the sales price. Hincapie has a contract with a service company, which performs all warranty work on Hincapie products. Under the contract, Hincapie guarantees the service company at least €200,000 of warranty work for each year of the 3-year contract.

The recent economic recession has been hard on Hincapie’s business, and sales for its higher-end products have been especially adversely impacted. As a result, Hincapie is planning to restructure its high-quality lines by moving manufacturing for those products into one of its other factories, shutting down assembly lines, and terminating workers. In order to keep some workers on-board, Hincapie plans to bring all warranty work in-house. It can terminate the current warranty contract by making a one-time termination payment of €75,000.

The restructuring plans have been discussed by management during November 2010; they plan to get approval from the board of directors at the December board meeting and execute the restructuring in early 2011. Given the company’s past success, the accounting for restructuring activities has never come up. Hincapie would like you to do some research on how it should account for this restructuring according to IFRS.

**Instructions**

Access the IFRS authoritative literature at the IASB website ([http://eifrs.iasb.org/](http://eifrs.iasb.org/)). When you have accessed the documents, you can use the search tool in your Internet browser to respond to the following questions. (Provide paragraph citations.)

(a) Identify the accounting literature that addresses the accounting for the various restructuring costs that will be incurred in the restructuring.
(b) Advise Hincapie on the restructuring costs. When should Hincapie recognize liabilities arising from the restructuring? What costs can be included? What costs are excluded?
(c) Does Hincapie have a liability related to the service contract? Explain. If Hincapie has a liability, at what amount should it be recorded?